What Price Bank Failure?

HELEN A. GARTEN*

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I. INTRODUCTION

Everyone talks about bank failure, but, like complaints about the weather, very little seems to be done about it. Although bank failures receive extensive press coverage,[1] the task of dealing with the consequences of failure has traditionally been left largely to the bank regulators.[2] Recently, these regulatory efforts have come

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* Associate Professor of Law, Rutgers Law School—Newark. A.B., Princeton University; J.D., Harvard Law School. I am grateful to the Rutgers University Research Council for its grant support for this project and to the S.I. Newhouse Faculty Research Fund of the Rutgers Law School for its ongoing assistance.

1. Especially recently, bank failure and problems in the banking industry attract front page attention. *See, e.g.*, Nash, *Large Texas Bank to Get $1 Billion in Federal Rescue*, N.Y. Times, Mar. 18, 1988, at A1, col. 6; Rehm, *FDIC Believes Tide Has Turned After Record Number of Failures*, Am. Banker, Jan. 5, 1989, at 1, col. 2 (200 banks failed in 1988). The ongoing crisis in the thrift industry also has focused attention on the solvency, or insolvency, of many commercial banks. For discussion of the impact of thrift problems on bank failure resolution techniques, see *infra* text accompanying notes 12–14 and 90–100.

2. Bank insolvency procedures differ from corporate bankruptcy and reorganization in a number of respects. When a bank becomes insolvent, it may be closed by its principal regulator, either the Comptroller of the Currency in the case of national banks or the relevant state chartering authority in the case of state-chartered banks. If the bank is federally insured, the Federal Deposit Insurance Corporation (FDIC) is appointed receiver and takes charge of paying insured depositors out of the deposit insurance fund and liquidating the bank's assets. *See* 12 U.S.C. § 1821(c) (1982). The FDIC also has the authority to arrange alternative dispositions of a failing insured bank either before or after it is formally closed. An example of the FDIC's flexibility to arrange solutions for problem banks was provided by the disposition of First RepublicBank Corporation of Dallas, Texas, a bank holding company with 41 subsidiary banks. Initially, the FDIC provided $1 million in emergency assistance directly to the subsidiary banks in order to reassure depositors and halt

under increased scrutiny and attack. In some cases, criticism has been directed at regulatory actions that prevent a bank from failing, for example, by providing direct financial assistance to keep a bank open[3] or by arranging its merger with a healthy institution.[4] These solutions are thought to dull the incentives created by the threat of failure for managers, shareholders, and creditors to operate banks responsibly.[5] Even when the regulators allow banks to fail, criticism has focused on deposit insurance[6] for removing incentives for insured depositors to monitor their banks.[7]

If these criticisms are valid, how should the regulatory system respond to bank failure? The obvious alternative to current bank failure policy is simply to treat bank failure like the failure of any other business firm. Such an approach would save the regulatory system the considerable administrative and capital costs currently incurred in arranging special dispositions of failing and failed banks.[8] In addition, it might even have a salutary effect on healthy banks and their investors. If bank investors faced the threat of loss as a result of bank failure, they might have an incentive to engage in better monitoring of bank risk.[9] Ideally, such improved monitoring would discipline opportunistic or high risk behavior by bank management, thereby preventing bank failure.[10]

Some aspects of the case for market discipline, such as the feasibility of en-

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deposit runs. The FDIC then began negotiations with potential purchasers of First RepublicBank's banking business. When the FDIC found an acceptable purchaser, the subsidiary banks were closed and their assets and liabilities transferred to a specially created bridge bank that initially was capitalized by the FDIC but that would be managed and eventually purchased by the acquiring bank. This disposition, which took approximately four months to arrange, ensured that neither creditors nor customers of the banks suffered any losses or interruptions in service. *See BHC Allowed to Acquire Bridge Bank*, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 87,416 (July 29, 1988). For a description of these and other methods of disposing of failed banks, see Bovenzi & Murton, *Resolution Costs of Bank Failures*, 1 FDIC BANKING REV. 1 (1988).

3. 12 U.S.C. § 1823(c) (Supp. V 1987); *see also supra* note 2 for an example of open-bank assistance. In order to provide open-bank assistance, the FDIC must determine that such assistance is less costly than liquidating the bank and paying off insured depositors out of the insurance fund or that the bank's continued operation is essential to provide adequate banking services in its community. 12 U.S.C. § 1823(c)(4)(A).

4. 12 U.S.C. § 1823(c)(2) (Supp. V 1987). Again, any financial assistance provided to arrange a merger must be less than the cost of liquidating the bank and paying off insured depositors, unless the bank's continued operation is essential to its community. 12 U.S.C. § 1823(c)(4)(A).

5. *See, e.g.*, Macey & Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153, 1184 (1988).

6. The bank insurance fund protects all deposits in insured banks up to $100,000 per depositor. 12 U.S.C. § 1813(m)(1) (1982).

7. Protection of these bank stakeholders from the consequences of their own excessive risk-taking is said to create a moral hazard problem. *See* E. KANE, THE GATHERING CRISIS IN FEDERAL DEPOSIT INSURANCE 14 (1985).

8. These costs include expenses of examining and appraising failed bank assets, financial assistance provided directly to a failing bank to keep it open or to an acquiring bank to permit it to assume a failed bank's liabilities, payments to insured depositors out of the insurance fund, administrative and legal costs associated with the liquidation of assets and collection of claims, and losses on assets or equity acquired by the FDIC from a failed bank. In recent years, these costs have grown. In 1988, for the first time in the FDIC's history, expenses exceeded both premiums paid by insured banks and investment income. Rehm, *FDIC's Shortfall Hit $10 Billion in '88*, Am. Banker, Apr. 26, 1989, at 1, col. 1. In 1989, the deficit in the sister thrift insurance fund required a major recapitalization. *See* Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (1989) [hereinafter FIRREA].

9. *See* Macey & Miller, *supra* note 5, at 1193–1225. This assumes that current bank failure policy prevents investor losses that would be suffered in corporate bankruptcy. In fact, this assumption is not completely accurate. *See infra* text accompanying notes 41–45.

10. *Id.* at 1226 (better monitoring would "not only reduce the high incidence of bank failures due to fraud and mismanagement, but would also reduce the incidence of failures due to insufficient asset diversification and fluctuations in the business cycle").

couraging more effective depositor discipline of bank risk-taking, have already been subject to extensive debate by this author and others.[11] This debate, and discussion of bank failure policy generally, have been given new urgency by recent events. The thrift industry crisis, which necessitated a costly recapitalization of the thrift insurance fund in 1989,[12] has demonstrated that deposit insurance funds are not invulnerable. This in turn has focused attention on the cost of bank failure to the bank insurance fund and to the government. Less costly alternatives to present failure resolution techniques are actively being sought.[13] At the same time, the problems experienced by the thrift industry have increased the responsibility and visibility of the bank regulators in handling failed depository institutions. As a result of the thrift restructuring legislation, the Federal Deposit Insurance Corporation (FDIC) has become responsible for administering both the bank insurance fund and the newly recapitalized savings association insurance fund, and for overseeing the disposition of distressed banks and thrifts.[14] The viability of the deposit insurance system thus depends on the success or failure of the FDIC's failed bank policy.

In this time of restructuring of the deposit insurance system, there is a real need to consider the interrelated problems of bank failure, regulatory disposition of failed banks, and the impact of that disposition on healthy banks and their investors. In this Article, I address several general concerns that are raised by the current debate over bank failure policy. First, any bank failure policy must address two separate problems: how to prevent banks from engaging in excessive risk-taking that is likely to result in failure, and how to deal with failure when it occurs. Many critics of current bank failure policy see a tradeoff between regulatory initiatives that seek to produce better managed banks, which can be described as "healthy bank policy," and those that seek to manage the consequences of failure, which can be described as "unhealthy bank policy." For example, it is assumed that if the quality of bank management could be improved, ideally through better market discipline, then bank failures could be avoided, removing the necessity for costly and undesirable regulatory intervention to prevent or minimize the adverse effects of a bank closing.[15]

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11. *See* Macey & Garrett, *Market Discipline By Depositors: A Summary of Theoretical and Empirical Arguments*, 5 YALE J. ON REG. 215 (1988); Garten, *Banking On the Market: Relying On Depositors to Control Bank Risks*, 4 YALE J. ON REG. 129 (1986) [hereinafter *Banking*]; Garten, *Still Banking on the Market: A Comment on the Failure of Market Discipline*, 5 YALE J. ON REG. 241 (1988) [hereinafter *Still Banking*]. I have argued that depositor discipline is unrealistic because many depositors have no incentive to monitor bank risk and that those who do judge bank safety on the basis of such factors as the likely regulatory disposition of the bank in the event of failure. Some readers may conclude from this that the failure of market discipline is the fault of regulation such as deposit insurance and special regulatory dispositions of failing banks. As this Article shows, this is not the case. Market discipline, by either depositors or shareholders, is an inefficient substitute for current bank failure policy.

12. *See supra* note 8.

13. Recently, there have been renewed calls for radical changes to the deposit insurance system, including limitations on insurance coverage. *See* FIRREA, *supra* note 8, § 1001 (commissioning new study of deposit insurance, including feasibility of reducing insurance coverage). Similar proposals have been considered—and rejected—in the past. *See, e.g.*, Federal Deposit Insurance Corporation, *Deposit Insurance in a Changing Environment* III-11 (1983) (earlier study of deposit insurance recommends changes in insurance coverage). It is noteworthy that the recent thrift reform legislation, although restructuring the thrift insurance fund, did not make significant changes in either basic insurance coverage or the regulators' choice of failure resolution techniques. *See* FIRREA, *supra* note 8.

14. *See* FIRREA, *supra* note 8, § 212 (giving FDIC authority to dispose of troubled thrifts as well as banks).

15. *See* Macey & Miller, *supra* note 5, at 1226.

This approach to bank failure policy is flawed in several respects. Initially, it assumes that only "bad" banks—those that are mismanaged or otherwise inefficient—fail. Further, it assumes that there is never any justification for regulatory intervention to prevent the failure of a bad bank. Yet not all bank failures represent either the weeding out of badly managed institutions or the transfer of resources to more efficient uses. Moreover, bank failure policy cannot be wholly, or even primarily, concerned with creating incentives for healthy banks to avoid failure.

Second, critics of current bank failure policy assume that the major stakeholders in a bank—managers, shareholders, depositors, and regulators[16]—share the same goals with respect to bank failure. For example, it is often assumed that encouraging a more active bank takeover market would create incentives for corporate raiders to identify and acquire those banks that are on the road to failure, thereby imposing market discipline on incumbent management.[17] But market discipline may mean different things to different people. This is particularly true in the market for corporate control. Shareholders shun companies with poor earnings, leading to depressed share prices. Companies with depressed share prices tend to be targets of acquisitions. Incumbent managers who fear takeovers therefore will feel pressure to improve earnings in order to raise share prices. But this may require management to take more risks, not fewer. The result may be market discipline, but it will not lead to fewer bank failures. Thus, the regulatory system cannot afford to rely too extensively on market forces to set a bank failure policy.

This Article explores these problems inherent in fashioning an effective bank failure policy. Part II considers the causes and effects of bank failure and refutes the notion that bank failure is a threat only to badly managed banks. It then describes the complex goals that must be served by a bank failure policy. Part III explains why bank failure policy cannot count on shareholders, depositors, or other creditors to exert market discipline that reduces either the frequency or the cost of bank failure. Part IV considers possible alternatives to current bank failure policy, such as facilitating a more active bank takeover market. It concludes that such an alternative at best will be ineffective and at worst will lead to even more frequent bank failure. Finally, Part V offers some suggestions for reconciling the goal of unhealthy bank policy—minimizing the cost of bank failure—with the goal of healthy bank policy—encouraging better managed and safer banks.

II. The Problem of Bank Failure

One's opinion of current bank failure policy generally reflects one's view of bank failure itself. If bank failure poses a threat to other healthy banks or the banking system, that threat may justify a regulatory policy designed to minimize these ex-

16. Other bank constituencies, such as customers and employees, are also concerned about bank failure. Yet the four stakeholders mentioned here are most directly implicated in bringing about the bank's failure as well as determining its ultimate disposition. *See infra* text accompanying notes 22–50.

17. *See* Macey & Miller, *supra* note 5, at 1203–12; *see generally* Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110, 112 (1965) (suggesting market for corporate control can function as a substitute for bankruptcy).

ternal or spillover effects of bank failure.[18] If, on balance, bank failure has a salutary effect, such as weeding out weak or inefficient institutions, then regulatory concern over the growing rate of bank failure may be misplaced.

Critics of current bank failure policy argue that the present fear of bank failure may be exaggerated. Since failure serves the beneficial function of eliminating mismanaged or uncompetitive banks, there is no reason for regulation to prevent bank failure.[19] Moreover, to the extent that regulatory policies do prevent failure, they discourage discipline by shareholders and depositors that would serve as a check on bank risk-taking.[20] Thus, bank failure policy should focus on encouraging better market discipline of healthy banks rather than preventing the failure of unhealthy banks.[21]

Initially, it is important to clarify what "failure" means in the context of regulated banks. Current bank failure policy does not prevent failure in the sense that all bank stakeholders—managers,[22] shareholders, depositors, and other creditors[23]—emerge with their interests in the bank intact. Rather, bank failure policy, like any bankruptcy policy, affects which stakeholders lose their investments and which are protected as a result of business failure. Bank failure differs from other business failure because of the FDIC's discretion to adopt alternative responses to bank failure that vary these gains and losses.

Recently, the FDIC has used five alternative methods of handling failing banks.[24] First, the FDIC may simply liquidate the bank, reimbursing the bank's insured deposits up to 100,000 dollars out of the insurance fund[25] and disposing of the bank's assets for the benefit of creditors,[26] including uninsured depositors (those with deposits in amounts over 100,000 dollars)[27] and the insurance fund itself, which is

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18. These externalities arise because of the inability of affected parties, such as investors in other banks injured by the failure, to allocate the cost of bank failure efficiently by private contract. For a discussion of the reasons for externalities in the marketplace, see generally Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

19. *See* Macey & Miller, *supra* note 5, at 1155.

20. *See id.* at 1172–93.

21. *See id.* at 1225 ("The goal of the regulatory system should be to provide private parties with incentives to monitor bank management and control excessive risk taking by banks").

22. Managers' stake in the continued viability of their banks results from their employment relationship, which is terminated if the bank fails, and the effect of failure on their professional reputations. In addition, many bank managers are also shareholders and depositors.

23. Another important stakeholder is the bank regulatory system itself. Under the deposit insurance scheme, the FDIC is responsible for administering the liquidation or reorganization of failed banks. Moreover, the insurance fund has a direct financial stake in bank failure, since the fund will bear the cost of paying off insured depositors or providing other assistance to facilitate the transfer of insured deposits to another bank. *See infra* text accompanying notes 24–40. More generally, if one bank failure has spillover effects on the operations of healthy banks, the banking system itself may be impaired. *See supra* text accompanying note 18.

24. This discussion of current alternatives relies heavily on Bovenzi & Murton, *supra* note 2, at 2–4. Since the FDIC is constantly experimenting with new, less costly approaches to handling failed banks, any description of current practices risks becoming rapidly out of date. The recently adopted thrift restructuring legislation made some changes in the FDIC's statutory authority to adopt alternative resolution techniques. *See* FIRREA, *supra* note 8, §§ 211–217 (amending 12 U.S.C. §§ 1821–23). These changes were largely technical and did not affect the FDIC's choice of alternative dispositions or discretion to adopt new approaches.

25. 12 U.S.C. § 1821(f) (1982), *amended by* FIRREA, *supra* note 8, § 212.

26. 12 U.S.C. § 1821(c),(d),(e) (1982), *amended by* FIRREA, *supra* note 8, § 212.

27. Such depositors will receive the first $100,000 of their investment from the insurance fund. For the rest, they generally are relegated to the bank's assets along with all other unsecured creditors. Some states may have depositor

subrogated to the claims of the insured depositors.[28] As a result, insured depositors are repaid in full, but uninsured depositors and other unsecured creditors receive only their proportionate share of collections on the failed bank's assets.[29] Bank shareholders, as well as shareholders and creditors of the failed bank's holding company, typically receive no special treatment.[30]

Second, the FDIC may arrange for a healthy bank to assume the failing bank's liabilities and some or all of its assets.[31] As a result, both insured and uninsured depositors and other creditors are generally protected, becoming creditors of the assuming bank. As the transfer usually takes place after the bank is declared insolvent and closed,[32] shareholders do not have to consent to the sale of assets. As in a deposit payoff, they are entitled only to their share of the proceeds of liquidation of any assets that are not transferred to the acquiring bank.[33] Since the acquiring bank is likely to purchase the best assets, very little will be left for shareholders in the ensuing liquidation.[34]

Third, the FDIC may arrange a purchase and assumption in which only insured deposits and secured liabilities are transferred to the acquiring bank.[35] In this case, uninsured depositors and creditors also must look to the proceeds of liquidation of any unpurchased assets for repayment of their claims.

Fourth, the FDIC may arrange some form of open-bank assistance.[36] Although technically such assistance prevents a failing bank from closing its doors, it is not

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preference statutes that give uninsured depositors in state-chartered banks priority over other general creditors in a liquidation.

28. 12 U.S.C. § 1821(g) (1982), *amended by* FIRREA, *supra* note 8, § 212.

29. In the past, these creditors ultimately have recovered a large proportion of their total investments. *See* FDIC ANN. REP. 1983 at 14 (as of end of 1983, 99.1 % of all depositors in bank liquidations were repaid in full). Nevertheless, such creditors are subject both to substantial delays before they receive any payment and to the risk that the bank's assets will turn out to be insufficient to satisfy all creditors in full. Since failed banks with valuable assets tend to be merged with healthy institutions rather than liquidated, this latter risk is very real. Occasionally, the FDIC has been willing to advance uninsured creditors a portion of their claims based on conservative estimates of the liquidation value of the bank's assets. *See* Bovenzi & Murton, *supra* note 2, at 2 n.2 (describing this "modified payoff").

30. As in any liquidation, bank shareholders (whether unaffiliated investors or a bank holding company) receive their proportionate share of any assets remaining after repayment of creditors. Since the claims of creditors (including uninsured depositors and the deposit insurance fund) in an institution as highly leveraged as a bank are likely to be substantial, few if any assets tend to be left over for shareholders to divide.

31. This transaction is called a "purchase and assumption." *See* Bovenzi & Murton, *supra* note 2, at 2. The FDIC generally must provide financial assistance to the purchaser to cover the difference between the value of the assumed liabilities and the acquired assets. *See* 12 U.S.C. § 1823(c)(2) (Supp. V 1987), *amended by* FIRREA, *supra* note 8, § 217 (permitting FDIC to advance funds to facilitate mergers of failed banks).

32. The bank's primary regulator has the discretion to make a determination of insolvency and close the bank. *See supra* note 2; *see also* Golden Pac. Bancorp v. Clarke, 837 F.2d 509, 512 (D.C. Cir.), *cert. denied*, 109 S. Ct. 223 (1988) (agency discretion to close insolvent bank not subject to judicial review absent arbitrariness or bad faith).

33. Shareholders still rank behind any remaining creditors of the failed bank, such as subordinated debtholders and the deposit insurance fund to the extent that the FDIC has advanced funds to arrange the purchase and assumption.

34. The FDIC tries to sell as many of the failed bank's assets as possible to the acquiring bank in order to minimize liquidation costs. *See* Bovenzi & Murton, *supra* note 2, at 3.

35. *See id.* at 3 (describing this "insured-deposit transfer"). The FDIC must advance sufficient cash to the acquiring bank to cover these liabilities. The acquiring bank will often use this cash to buy some of the failed bank's assets.

36. Such assistance may be provided to prevent a bank from closing, to restore a closed bank to normal operations, or when severe financial conditions exist that threaten the stability of a significant number of insured banks or the stability of insured banks possessing significant financial resources. 12 U.S.C. § 1823(c)(1) (Supp. V 1987), *amended by* FIRREA, *supra* note 8, § 217. For an example of the use of open-bank assistance, see *supra* note 2.

intended as a subsidy to shareholders or management. As a condition to granting assistance, the FDIC requires the infusion of substantial new private capital, which reduces existing shareholders' interests in the bank.[37] In addition, the FDIC generally insists on the replacement of incumbent management.[38] The claims of depositors and other bank creditors are preserved intact. Occasionally, open-bank assistance is designed to keep the bank open until a permanent solution, such as a purchase and assumption, can be arranged.[39]

Finally, the FDIC may create a new "bridge" bank to assume the assets and liabilities of the failing bank until a permanent solution can be arranged.[40] As in a purchase and assumption, depositors and other bank creditors become creditors of the assuming bank. Shareholders must satisfy their claims out of whatever assets remain in the failed bank.

Thus, whatever the disposition, a failed bank's managers and shareholders suffer losses similar to those experienced by managers and shareholders in nonbank business failure.[41] If the failed bank is owned by a bank holding company, the holding company's shareholders and debtholders generally receive no special protection regardless of whether the bank is liquidated, merged with a healthy bank, or receives open-bank assistance.[42] In fact, bank holding company investors may be in a worse position than investors in a nonbank conglomerate with a bankrupt subsidiary. Since the bank is the most important asset of most bank holding companies, its liquidation or transfer may leave the bank holding company without adequate sources of funds to pay its own debt, resulting in its bankruptcy.[43] Further, whenever possible, the bank regulators have an interest in forcing the bank holding company to use the resources of its healthy banking and nonbanking operations to bail out a failing bank

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37. *See* FDIC, Statement of Policy and Criteria on Assistance to Operating Insured Banks, 51 Fed. Reg. 44,122 (Dec. 8, 1986) [hereinafter *FDIC Statement*].

38. *See id.* For example, in providing open-bank assistance to First City Bancorporation of Texas, the FDIC required the bank holding company to raise $500 million in new equity capital, reducing the interest of existing shareholders to less than three percent of total equity. The FDIC also insisted on new management. *See FDIC Agrees to Assistance Plan for Texas BHC Subsidiary Banks*, [1987-1988 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 87,067 (Sept. 9, 1987). Existing shareholders may prefer to keep a three percent interest in an ongoing institution rather than to incur the uncertainty and delays of a liquidation. In this sense, they are "better off" with open-bank assistance than with other regulatory dispositions of failed banks. *See* Macey & Miller, *supra* note 5, at 1176. Nevertheless, in either case, the potential losses are substantial enough that shareholders should prefer to avoid bank failure entirely.

39. *See supra* note 2 (describing disposition of First Republic). Generally, the terms of assistance provide for eventual repayment with interest by the bank or any successor. *See FDIC Statement*, *supra* note 37, at 44,122. For an example of one such arrangement, see *infra* note 44 (First Republic).

40. *See* 12 U.S.C. § 1821(i) (Supp. V 1987), *amended by* FIRREA, *supra* note 8, § 214; *see also supra* note 2.

41. In fact, the cost of failure may be greater for bank managers and shareholders than for nonbank managers and shareholders. *See infra* text accompanying notes 43–45.

42. The regulatory disposition of Continental Illinois in 1984 was an exception to this practice. The FDIC's financial assistance plan guaranteed protection to bank holding company creditors as well as bank creditors. *See Comprehensive Financial Assistance Plan Set for Continental Illinois National Bank*, [1983-1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 99,972 (May 17, 1984). Since then, the FDIC has indicated that it will not protect shareholders or creditors of a failed bank's holding company. *See FDIC Statement*, *supra* note 37, at 44,123 (impact of open-bank assistance on holding company directors, management, shareholders, and creditors should approximate what would be expected had the subsidiary bank failed).

43. This happened in the case of First RepublicBank Corporation, which was forced to declare bankruptcy after its banking assets were transferred to a bridge bank. *See supra* note 2; *see also* Klinkerman, *Texas Bank Rescues Pit Wall Street Investors Against Regulators*, Am. Banker, Nov. 29, 1988, at 12, col. 4 [hereinafter *Texas Bank*].

subsidiary.[44] For example, the FDIC has required healthy bank subsidiaries to guarantee federal financial assistance provided to their failing bank subsidiary and has demanded that a bank holding company contribute nonbanking resources to its failing subsidiary banks as a condition to receiving FDIC assistance.[45]

Therefore, the principal difference among the alternative regulatory responses to bank failure is whether or not they result in protection of uninsured depositors and other creditors of the failed bank.[46] Debate over current bank failure policy ultimately can be reduced to the question of whether these particular creditors should be winners or losers in bank failure. Critics of bank failure policy argue that special protection of uninsured creditors is not justified, and may interfere with the market discipline created by the threat of failure.[47]

This argument ignores the reasons why, in some bank failures, regulatory disposition has had the effect of protecting uninsured as well as insured depositors. First, not all bad banks fail, nor are all banks that fail necessarily bad banks. Thus, using bank failure policy to penalize depositors who have invested in a failed bank will not necessarily encourage depositors to avoid badly managed banks.

Second, the process of business failure and reorganization is itself costly. Failure rarely means the welcome demise of an inefficient business. Instead, it signals the beginning of a lengthy bargaining process among stakeholders. During this bargaining, assets are tied up. Creditors' funds are frozen. Managers and employees are demoralized. Customers are in limbo. Ironically, the methods of failure resolution about which critics of bank failure policy complain the most, such as federally assisted mergers[48] and open-bank assistance,[49] actually minimize these costs of failure by facilitating the rapid transfer of an intact banking business to new owners or managers.

Finally, there are important reasons to be concerned about bank failure apart from its effect on uninsured depositors. Deposit insurance gives certain innocent bystanders—healthy banks and their depositors, the bank regulatory system, and the public—a stake in bank failure that is more direct than the stake of competitors, government, or the public in other business failure. Any bank failure imposes costs on

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44. In 1988, the FDIC required that its $1 billion loan to First Republic's lead bank be guaranteed by each of First Republic's bank subsidiaries. When the FDIC called the loan following the insolvency of First Republic's lead bank, the remaining banks were unable to meet their obligations under the guarantees and were declared insolvent and closed. The FDIC then arranged the sale of all the banks to a new owner, leaving the holding company's shareholders and creditors with no healthy bank assets. *See BHC Allowed to Acquire Bridge Bank*, *supra* note 2, at ¶ 94,056. Recently enacted thrift restructuring legislation explicitly authorizes the FDIC to seek reimbursement of losses incurred in disposing of a failed bank from its affiliated banks or thrifts. *See* FIRREA, *supra* note 8, § 206.

45. For example, the FDIC insisted that MCorp, a Texas bank holding company, contribute $400 million of nonbank assets to bail out its failing subsidiary banks. *See Texas Bank*, *supra* note 43, at 3, col. 1. Although the FDIC's attempt to force such a contribution was unsuccessful, the FDIC subsequently asserted claims against the bankrupt holding company for costs incurred in arranging the sale of its failed bank subsidiaries. *See* Klinkerman, *FDIC Sees Quick Sale of Closed MCorp Units, Parent Faces Years of Legal Struggles*, Am. Banker, Mar. 30, 1989, at 1, col. 2.

46. There may also be a difference in impact on bank borrowers and other customers. In a liquidation, these banking relationships may be terminated, while other forms of disposition may result in the transfer of loans and other business intact to a healthy bank. *See infra* text accompanying note 82.

47. *See* Macey & Miller, *supra* note 5, at 1181.

48. *See supra* text accompanying notes 31–35.

49. *See supra* text accompanying notes 36–39.

the deposit insurance fund. If these costs are too great, they may result in higher deposit insurance premiums for healthy banks (and presumably higher charges for bank customers)[50] and loss of public confidence in the deposit insurance system. These costs of failure resolution affect how any individual bank failure is handled. Thus, the regulatory system cannot afford the luxury of a bank failure policy designed to achieve market discipline.

A. *Bank Failure and Bad Banks*

Critics of bank failure policy occasionally extol the virtues of bank failure. Bank failure is a sign that "innovation is driving obsolete firms out of the industry, or that competition is driving inefficient firms out of the market."[51] If it is desirable that inefficient industrial firms fail so that their resources may be transferred to more productive uses, "it is doubly desirable that an inefficient bank fail."[52] These arguments in favor of bank failure assume that banks fail solely because of mismanagement—problems ranging from insider fraud to simply poor managerial decisions such as inefficient diversification.[53] If "broad-based fluctuations in the economy are no longer a significant source of bank failure,"[54] then even depositors should not be concerned that one bank failure will cause deposit runs at other healthy banks. Bad management, unlike liquidity problems or economic crises, is not contagious.

This view of the causes and effects of bank failure may be reassuring to observers concerned about the increasing rate of bank failure, but it is also overly simplistic. Management error, whether actual misconduct or negligence, obviously contributes to a bank's problems, but less firm-specific factors, such as economic conditions, government policies, and public confidence in banks, also play a role. In times of prosperity for the banking industry, many poorly managed banks are able to survive. This is suggested by the extraordinarily low rate of bank failure from the 1940s through the 1970s.[55] The last generation of bank management may have been more competent than today's managers. But it is more likely that the profitability of the banking industry generally allowed many managers to hide their mistakes.

In contrast, declining profitability in traditional banking businesses, intense competition from nonbank firms and poor economic conditions can make the slightest of management mistakes fatal for a bank.[56] This is dramatically illustrated by the

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50. Although the competitiveness of the lending market may prevent banks from passing on these costs in the form of higher interest charges on loans, banks can raise fees for nonlending services and pay below-market rates of interest on deposits such as transaction accounts that are relatively insensitive to modest changes in interest rates. *See Banking*, *supra* note 11, at 134–37 (arguing that many depositors do not expend resources to shop for marginally better returns on their deposits).

51. *See* Macey & Miller, *supra* note 5, at 1155.

52. *See* Tussing, *The Case For Bank Failure*, 10 J.L. & ECON. 129, 146 (1967).

53. Macey & Miller, *supra* note 5, at 1169–71.

54. *Id.* at 1172.

55. From 1934 to 1943, an average of 43 banks failed per year. From 1944 to 1974, fewer than 10 banks failed per year. *See* Huber, *Mandatory Disclosure of Information About Banks*, 6 B.U. ANN. REV. BANKING L. 53, 57–58 (1987). In contrast, in 1988, 200 banks failed. *See* Rehm, *supra* note 1, at 1, col. 2.

56. These forces have affected banks during the past two decades. For a description of recent pressure on bank profitability, and of the reaction of the banking industry, see generally Garten, *Regulatory Growing Pains: A Perspective on Bank Regulation in a Deregulatory Age*, 57 FORDHAM L. REV. 501 (1989) [hereinafter *Growing Pains*].

banking crisis in Texas in the late 1980s.[57] Although in many cases mismanagement was a factor leading to bank failure, the depressed Texas economy also was responsible for banking woes.[58] In any individual case, it is unclear which factor was primarily to blame.[59]

In hindsight, of course, managers can be faulted for failing to take steps to protect their banks from general economic threats. For example, Texas banks might have diversified their assets by making loans to borrowers in New York or Illinois, or investing in less risky assets, such as government securities. Yet these choices could have created new and equally serious risks. Asset diversification requires bankers to make loans to new industries and in regions of the country with which they have limited experience or expertise. As a result, credit analysis and loan administration may suffer.[60] Likewise, in today's competitive banking environment, investing in safe assets, such as government securities, means sacrificing return at a time when bank liabilities are becoming increasingly costly.[61] Thus, there may be no such thing as a fail-safe banking policy.[62]

Finally, the precipitating cause of many bank failures is a liquidity crisis: too many depositors demand their funds, or the bank cannot obtain sufficient new deposits to cover funding needs. Once a large number of depositors start withdrawing their funds, any bank can experience a funding crisis and fail. Moreover, this crisis itself will cause any remaining depositors to run to withdraw their funds before the

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57. *See* McTague, *Texas Failures Push Midyear Talley to 102 Banks*, Am. Banker, July 6, 1989, at 9, col. 2 (68 Texas banks failed in first half of 1989). In a three-year period, nine of the top ten bank holding companies in Texas were sold in distress sales or needed federal financial assistance. *See* Klinkerman, *FDIC Decides How to Rescue Two Texas Banks*, Am. Banker, July 21, 1989, at 1, col. 1. At least one such bank subsequently required a second rescue. *See* Klinkerman, *BancTexas Needs Another Rescue*, Am. Banker, July 28, 1989, at 1, col. 1.

58. *See, e.g.*, Nash, *Large Texas Bank to Get $1 Billion in Federal Rescue*, N.Y. Times, Mar. 18, 1988, at A1, col. 6 (FDIC Chief says economic factors rather than mismanagement were primary cause of First Republic's problems).

59. A study by the Comptroller of the Currency concluded that, although management weakness played a role in most bank failures, poor economic conditions were a significant cause of problems in more than one-third of the banks surveyed. *See OCC Study Evaluates the Factors Contributing to the Failure of National Banks*, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 87,387 (June 1988).

60. For example, Continental Illinois' problems may have been due in part to the Chicago bank's aggressive diversification into new lending areas, such as energy lending in the Southwest, in which the bank lacked experience.

61. High interest rates on competitive investments, such as money market mutual funds, have forced banks to pay higher rates on their deposits, increasing their cost of funds. This has greatly complicated management of interest rate risk. Banks no longer can be sure of a positive spread between the rates they can earn on their assets and the rates they must pay on their liabilities.

62. Some critics still suggest that today it is easier than ever for a bank to acquire a substantial volume of essentially riskless assets. Macey & Miller, *supra* note 5, at 1172 (paraphrasing Tussing, *supra* note 52, at 136). Curiously, they rely for this proposition on an article that was published in 1967, before the revolution in the banking and financial services industries that occurred in the 1970s and 1980s. Since 1970, economic and legal developments such as sustained periods of high interest rates, deregulation of interest payable on bank deposits, and the growth of the commercial paper market as an inexpensive alternative to bank loans for many corporate borrowers have fundamentally changed the business of banking, reducing profitability and increasing risk in traditional banking activities. Thus, the banking business of the late 1980s is very different from the banking business of the late 1960s. Today, a bank that acquires a substantial volume of riskless (and low yielding) assets may be unable to pay sufficient interest on its deposits to attract investors and fall victim to a liquidity crisis—or may be taken over by a raider who is less risk averse.

regulators decide to close the bank.[63] Thus, deposit runs take on a life of their own, creating a special risk for the bank.[64]

Of course, if a deposit run is occurring because depositors have identified the bank as badly managed, the run and subsequent bank failure may not be completely undesirable.[65] But depositors are not always able to identify bad banks. For example, assume that Bank A fails due to insider fraud. Depositors in neighboring Bank B have an interest in learning why Bank A failed and whether the same risk exists at Bank B. So long as these depositors can assure themselves that the misconduct that caused Bank A's failure does not threaten Bank B, they have no reason to withdraw their funds from Bank B.

Yet management fraud is very difficult for depositors to detect.[66] Depositors may be unable to identify exactly what caused Bank A's failure or to evaluate the risk to Bank B. These depositors may decide simply to remove their funds from Bank B. Other depositors, seeing this, will follow suit.[67]

Of course, the failure of any one bank does not necessarily lead to panic and deposit runs at all other banks, any more than the failure of a nonbanking firm necessarily leads to panic among securities investors generally. Nevertheless, several factors make runs more likely in the market for deposits than in the equity market. First, like any investor facing uncertainty about the solvency of a firm, a depositor may choose either to liquidate her investment or to verify rumors before making a decision to hold or sell. This choice depends on the relative costs of exit and monitoring. For a shareholder, neither route is costless. Monitoring requires the shareholder to incur the expense of acquiring and verifying information. Exit involves selling the security in the secondary market, requiring the shareholder to pay brokerage fees and to assume the risk of a declining market price.[68]

In contrast, the deposit contract allows the holder to redeem her investment

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63. This phenomenon has been predicted by economic models of strategic depositor behavior. *See, e.g.*, Chari & Jagannathan, *Banking Panics, Information, and Rational Expectations Equilibrium*, 43 J. FIN. 749 (1988); Diamond & Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401 (1983). It has been demonstrated by experience with real-life deposit runs. *See, e.g.*, Hayes, *First RepublicBank in Bailout Talks*, N.Y. Times, Mar. 17, 1989, at D6, col. 2 (deposit run on large Texas bank).

64. Some critics have suggested that banks can avoid liquidity crises by matching the durations of their assets and liabilities. Macey & Miller, *supra* note 5, at 1157. Theoretically, every deposit would be matched with an asset that matures at exactly the same time that the deposit becomes withdrawable. But this precise matching is impossible. Banks depend for funding on demand deposits that may be withdrawn at any time without penalty. Unexpectedly heavy withdrawals of demand deposits may leave a bank with insufficient cash to repay other maturing liabilities. If the bank then is forced to sell assets quickly to raise cash, it may not be able to realize their full value. The secondary market for many bank assets, such as commercial loans, does not yet offer the same liquidity as markets for actively traded debt securities such as treasury bills.

65. Runs even on bad banks can have undesirable distributional consequences. Runs result in unequal treatment of depositors, favoring those depositors who reach the bank first, and strip the bank of cash and other assets that otherwise would be available for other creditors in bankruptcy.

66. Even the bank regulators have had difficulty uncovering fraud and insider abuse at banks. *See* HOUSE COMM. ON GOVERNMENT OPERATIONS, FEDERAL RESPONSE TO CRIMINAL MISCONDUCT AND INSIDER ABUSE IN THE NATION'S FINANCIAL INSTITUTIONS, H.R. REP. NO. 1137, 98th Cong., 2d Sess. 9 (1984) (finding that banking agencies frequently fail to detect insider criminal misconduct prior to failure). Certainly, depositors cannot be expected to uncover what the regulators so often miss.

67. *See supra* text accompanying notes 63–64.

68. For a discussion of these and other information costs faced by participants in the securities markets, see Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 594–95 (1984).

without penalty upon demand or at regular short-term intervals. In order to exit, most depositors do not have to incur the cost of a secondary market transaction or the risk of a declining market price.[69] Since liquidation is virtually costless, depositors are likely to react to uncertainty about bank condition by simply refusing to reinvest maturing deposits rather than by incurring the expense of searching for and verifying information about their banks.[70]

Second, unlike a shareholder, a depositor does not have to incur substantial search costs to find an alternative investment for her funds. The depositor can reinvest in any number of alternative short-term debt instruments, such as treasury securities, commercial paper, money market mutual funds, and deposits in other banks. These investments offer depositors rates, maturities, and risks that are comparable to those of their original deposits and can be acquired and liquidated virtually without cost. The fungibility of these short-term investments facilitates rapid reinvestment of liquidated deposits.[71]

Third, deposit withdrawals result in an immediate loss of capital for the bank. Such withdrawals have a more direct impact on a bank's financial position than a decline in the market price of a firm's shares as a result of panic selling by securities holders.[72] Deposit runs can be self-fulfilling prophecies: the withdrawals themselves affect the financial stability of the bank, providing a motive for remaining depositors to withdraw their funds.

These inherently destabilizing characteristics of the deposit market are sufficiently complex to warrant more detailed consideration later in this Article.[73] The problem for bank failure policy is not the certainty of the impact of one bank's failure on other banks, but its very unpredictability. For example, the failure of a small Ohio thrift institution in 1985, although due to firm-specific mismanagement, led to de-

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69. Some deposits are sufficiently long-term that exit may require use of a secondary market. An active secondary trading market does exist for large wholesale certificates of deposit. In relying on this market for exit, the depositor will incur trading expenses and the risk of a declining market price, but for many depositors these costs still may be less than the cost of verifying rumors. *See infra* note 70. Moreover, other factors, such as the ready availability of substitute investments, encourage exit rather than monitoring. *See infra* text accompanying note 71.

70. Recent improvements in bank disclosure and ratings have substantially lowered monitoring costs for some bank investors. *See Banking*, *supra* note 11, at 139–43. Nevertheless, for many depositors, particularly small retail depositors, obtaining accurate information about banks remains costly. Such depositors do not use brokers or investment advisers in making their deposits and do not follow private sector or regulatory financial analysis. In any event, when a bank is experiencing financial distress, its condition may change so rapidly that current information is hard to come by. Depositors will look for signals in the behavior of other depositors. If other depositors are withdrawing their funds, less informed depositors will simply follow suit.

71. In fact, today there are so many alternatives to deposits that banks no longer have a monopoly on short-term liquid investments. *See Growing Pains*, *supra* note 56, at 522–23 (discussing growth of deposit substitutes).

72. *See* Fama & Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327, 338 (1983).

73. *See infra* text accompanying notes 143–48. Some of these attributes of the deposit market are present in other short-term debt markets, notably the commercial paper market. Therefore, the failure or default of one commercial paper issuer might be expected to have similar spillover effects on the entire commercial paper market. In the past, this has been the case. *See* W. MELTON, INSIDE THE FED: MAKING MONETARY POLICY 157–58 (1985) (1970 bankruptcy of Penn Central, which had $82 million of commercial paper outstanding, led to run on commercial paper market). This danger of panic has led to a "flight to quality" by commercial paper investors, effectively foreclosing the market to all but the most creditworthy issuers. *Id.* at 29. In contrast, the deposit market remains open to all banks. Moreover, many of the most active marketers of deposits are banks in precarious financial positions. *See infra* text accompanying note 141.

posit runs at other, better managed institutions.[74] Publicity in 1989 about the crisis in the thrift industry and doubts about the solvency of the thrift insurance fund led to deposit runs at many savings associations although the problems affecting the thrift industry were hardly new.[75]

Although panic runs are rare today compared with the deposit runs of the 1930s, the primary deterrent is government regulation designed to prevent panics. This bank "safety net" includes deposit insurance, Federal Reserve lending to institutions experiencing liquidity crises,[76] and bank failure policy itself. Each of these devices has the effect of protecting depositors from losses in the event of a liquidity crisis and failure, thereby dulling their incentive to join deposit runs. Whether in the absence of any part of this regulation, deposit runs once again would become common is a hypothesis that even critics of bank failure policy are reluctant to test.[77]

Thus, bank failure is a more complex phenomenon than simply a way to eliminate bad banks. Banks fail for a variety of reasons, both firm-specific and systemic. More important, the inability of depositors to identify firm-specific causes for all bank failures means that bank runs will not necessarily be confined to bad banks. This problem of erroneous depositor discipline complicates the goals of bank failure policy.

B. *Bank Failure and Insolvency Procedures*

Failure even of a badly managed firm does not automatically result in the efficient redistribution of its assets to more desirable uses. Rather, failure begins a long and complex bargaining process as the business is reorganized or sold and the claims of its various stakeholders are balanced. This process imposes considerable costs on the parties to the reorganization proceeding and on others affected by the failure, including customers, employees, and the public.[78] Lengthy proceedings re-

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74. These runs were caused by questions as to the solvency of state deposit insurance funds generally. *See* Kilborn, *World Markets React to Ills of U.S. Banks*, N.Y. Times, Mar. 20, 1985, at D9, col. 5.

75. *See* McTague, *Thrifts Report $45 Billion Drop in Deposits Since May 1988*, Am. Banker, Mar. 15, 1989, at 1, col. 2. Ironically, thrift regulators blamed the outflows not on bad publicity about the thrift industry, but on rate competition from money market funds. Even if this were true, it only confirms the unpredictability of the deposit market. At a time when multiple thrift failures were bringing into question the solvency of the thrift deposit insurance fund, depositors might have been expected to have already abandoned thrifts regardless of rates.

76. *See* 12 U.S.C. § 347(b), 411–12 (1982).

77. Most critics of bank failure policy admit that there is a need for deposit insurance and central bank lending to deter deposit runs. *See* Macey & Miller, *supra* note 5, at 1158; Fischel, Rosenfield & Stillman, *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 312–18 (1987). Yet bank failure policy performs exactly the same function. For example, the regulators' announcement that any disposition of ailing Continental Illinois would preserve the claims of all depositors and creditors of the bank and bank holding company was intended to halt a deposit run. *See supra* note 42. Moreover, as a way of deterring runs, bank failure policy may have fewer negative side effects than central bank lending, which provides liquidity to inefficient banks and their inefficient managers even after the market has refused to fund them. Dispositions of failed banks that protect all depositors at least ensure that some discipline is imposed on management and shareholders. *See supra* text accompanying notes 41–45.

78. For a discussion of these costs, *see* Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 528, 529 (1983). At least one study has suggested that the legal and administrative costs of corporate bankruptcy are less significant than is commonly assumed. *See* Warner, *Bankruptcy Costs: Some Evidence*, 32 J. FIN. 337, 343 (1971) (study of 11 railroad bankruptcies found that bankruptcy costs averaged only 1 % of firm value 84 months prior to bankruptcy). But this study was concerned only with the firm's expenses, not losses experienced by customers, employees, and the government. Moreover, the study took into account only out-of-pocket expenses, such as

quire considerable investment of judicial time. Investors' funds are tied up until the reorganization or liquidation is complete, preventing their immediate reinvestment in more productive uses. Customers and employees with an ongoing relationship with the failed firm experience uncertainty. Customers may be forced to establish relationships with new businesses. Employees may become demoralized and seek new employment.

In comparision with corporate bankruptcy and reorganization procedures, bank failure policy actually may be more efficient in facilitating the rapid transfer of resources to productive uses. First, regulatory dispositions of failed banks generally result in the prompt removal of shareholders and management from the bargaining process. Whether the bank is liquidated or its assets and liabilities are transferred to another bank, its managers immediately lose their jobs. Shareholders have no say in the disposition of the bank and are relegated to the FDIC's liquidation proceedings to recover any part of their claims.[79] Even if the bank receives open-bank assistance, the FDIC may fire incumbent management and insist that shareholders reduce their interests in the bank.[80] Thus, the FDIC's power to determine the fate of a failed bank and to provide or withhold financial assistance to a failing bank enables the FDIC to impose solutions on management and shareholders that may not be possible in corporate bankruptcy.[81]

Second, some bank failure resolution procedures facilitate an orderly and rapid disposition of the failed bank's valuable resources. In a federally assisted merger, depositors' and other creditors' claims are assumed virtually without interruption by the acquiring bank.[82] Creditors do not have to find new investments that offer comparable rates of return. Depositors have uninterrupted access to their funds. Moreover, the assuming bank usually purchases some or all of the failed bank's performing assets. Thus, lending relationships are not terminated; borrowers simply make their interest payments to a new bank. In contrast, when a failed bank is liquidated, many loans will be called, forcing borrowers to find new sources of credit. Borrowers may

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legal and professional fees, trustee fees and filing fees, and not the indirect costs of bankruptcy, such as lost human capital, lost sales, and higher financing costs.

79. *See supra* text accompanying notes 25–35.

80. *See supra* text accompanying notes 36–38.

81. In corporate reorganization, incumbent management frequently continues to operate the firm until a final settlement is reached, which may leave management in power for several years. Moreover, prior to the commencement of formal bankruptcy proceedings, shareholders have little incentive to compromise their claims. Creditors often are unable to force prebankruptcy recapitalizations or changes of control due to inadequate bargaining power, conflicting interests, and even legal impediments to altering the terms of their own investments. *See generally* Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232 (1987) (Trust Indenture Act provision prohibiting binding vote by bondholders to change core indenture terms inhibits pre-bankruptcy workouts).

Of course, not even the FDIC can always force shareholders and managers to accept a prebankruptcy reorganization. For example, when the FDIC insisted that a bank holding company contribute nonbank resources to its ailing subsidiary banks as a condition to receiving open-bank financial assistance, bank holding company management simply refused. *See* Klinkerman, *MCorp, Raising Stakes, Hints at Bankruptcy This Week*, Am. Banker, Nov. 1, 1988, at 2, col. 1. Ultimately, the regulators had to close the banks, transferring their assets to a bridge bank pending sale. As a result, the holding company lost control of over 80 % of its assets. *See* McTague, *FDIC Sees Quick Sale of Closed MCorp Units, $15.4 Billion in Assets Seized After Deposit Run*, Am. Banker, Mar. 30., 1989, at 1, col. 4.

82. The FDIC tries to arrange the sale before the bank is closed so that the bank can be closed and reopened under new ownership overnight. *See* Bovenzi & Murton, *supra* note 2, at 2–3. If the FDIC provides open-bank assistance, the bank's ongoing relationships with creditors and borrowers are unaffected.

be unable to renegotiate the terms of their loans when their creditor is a receiver in liquidation.

Finally, the FDIC's discretion to choose alternative dispositions of failed banks generally is constrained by the resulting cost to the insurance fund.[83] Open-bank assistance or transfer of the failed bank's assets and liabilities to a healthy bank is preferable to a liquidation if the amount of financial assistance required to arrange such a disposition is less than the cost of paying off insured depositors and liquidating assets.[84] Thus, the FDIC is required to identify and implement the most efficient solution to any particular bank failure.[85]

C. *Bank Failure and Deposit Insurance*

Critics of bank failure policy still complain that the FDIC has too much discretion to arrange alternative dispositions of failed banks. They see little need for extensive regulatory involvement in bank failure, especially the FDIC's efforts to arrange mergers or to recapitalize failing banks. Such efforts are particularly objectionable when they result in the protection of what are viewed as undeserving groups of stakeholders, such as uninsured depositors. These depositors should be sophisticated enough to protect themselves from bank failure and, if they have invested in a failing bank, should bear the consequences of their own actions.[86]

This criticism fails to take account of the legal and political constraints that have contributed to the development of current bank failure policy. Far from exercising unbounded discretion in determining the fate of failed banks, the FDIC authority actually is subject to limits that do not affect a bankruptcy court overseeing a corporate reorganization. Further, whether or not regulatory dispositions of failed banks protect undeserving depositors often is beside the point. Bank failure policy is not determined by weighing the relative claims of different bank stakeholders for

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83. *See* 12 U.S.C. § 1823(c)(4) (Supp. V 1987), *amended by* FIRREA, *supra* note 8, § 217 (limiting financial assistance to, or to facilitate the merger of, a failed bank to amounts not in excess of the cost of liquidation and payment of insured depositors). In calculating the cost of financial assistance, the FDIC must take into account both immediate cash outlays and long-term obligations as well as any lost tax revenues as a result of tax benefits provided to facilitate the acquisition of the failing bank. *See* FIRREA, *supra* note 8, § 217.

84. The FDIC can ignore this cost test if it makes a determination that the continued operation of the failing bank is essential to provide adequate banking services in its community. 12 U.S.C. § 1823(c)(4) (Supp. V 1987), *amended by* FIRREA, *supra* note 8, § 217. Despite this loophole, the FDIC has made relatively few "essentiality" determinations. Moreover, in some of these cases, the FDIC's disposition ultimately has turned out to be less costly than liquidation. *See* Sprague, *FDIC Is Less Inclined to Genuine Bailouts than FSLIC*, Am. Banker, Mar. 15, 1989, at 4, col. 2.

85. The FDIC is accorded virtually unlimited discretion to determine which disposition is most cost-effective. *See* 12 U.S.C. § 1823(c)(4) (Supp. V 1987), *amended by* FIRREA, *supra* note 8, § 217 ("No assistance shall be provided . . . in an amount in excess of that amount *which the Corporation determines* to be reasonably necessary to save the cost of liquidating, including paying the insured accounts of, such insured bank" (emphasis added)). Moreover, the impossibility of predicting the actual cost of liquidating a bank, including the prices at which its assets eventually can be sold, creates the risk that the FDIC will err in applying the cost test. Nevertheless, the FDIC has strong incentives to avoid deliberate or accidental miscalculations, since costly errors are likely to have a negative impact on the agency's future funding and authority. This was the fate of the now defunct Federal Home Loan Bank Board following its perceived mishandling of various thrift failures. *See, e.g.*, Rowe, *Such a Deal! Is the Bank Board's Southwest Plan Too Good to Be True?* Am. Banker, Nov. 17, 1988, at 6, col. 1 (criticizing federal financial assistance plan for failed thrifts as overly generous to private acquirors); *see also infra* text accompanying note 97.

86. *See supra* text accompanying notes 19–21.

protection. Rather, bank failure policy increasingly has a single aim: to minimize the effect of bank failure on the insurance fund.

Deposit insurance alters the stakes in a bank failure in a fundamental fashion. Even critics of bank failure policy admit that, at a minimum, deposit insurance must continue to protect some class of depositors.[87] Although the original concept of protecting small savers may appear paternalistic (particularly when those savers include investors with 100,000 dollars in a single bank) or unnecessary (when there are other more effective ways to protect small savers), deposit insurance has become a permanent part of the banking system. Moreover, it benefits the banking industry as well as the depositor. Deposit insurance enables banks to offer relatively low premiums and still attract funds in today's competitive liability market.[88] It reassures depositors who otherwise might react to bad publicity about foreign lending, bank fraud, and the thrift industry crisis by removing their funds from the bank, or pressuring Congress for more stringent regulation of the banking industry.

Yet the very success of deposit insurance has created its own risk. Any doubts about the solvency of the insurance fund can spark a severe negative reaction from depositors. When very few banks failed, the strength of the insurance fund was not in doubt. Yet recent questions about the solvency of comparable funds, such as the state guarantee funds in Ohio[89] and the federal thrift insurance fund,[90] have suggested that deposit insurance funds are not bottomless and that any fear about the solvency of an insurance fund can trigger deposit runs.

Therefore, like any reserve fund, the deposit insurance fund ultimately is limited in the guarantee it can offer depositors.[91] This constraint has shaped bank failure policy. The best way to protect a reserve fund is to use it as little as possible. Bank failure policy has aimed to arrange dispositions of failed banks that require less cash outlay than paying off insured depositors out of the insurance fund.[92] Of course, unlike private insurers, the deposit insurance fund does not have to depend entirely on premiums from insured parties for funding.[93] The government always can print additional money or raise taxes to bail out the fund.[94] Nevertheless, political con-

87. *See* Macey & Miller, *supra* note 5, at 1158. There is disagreement over which depositors are deserving of insurance protection. *See supra* note 13 (proposals to cut back on present $100,000 per depositor coverage).

88. Given the relative safety of recent deposit substitutes such as money market mutual funds, this competitive advantage provided banks by deposit insurance may be waning. *See supra* text accompanying note 71.

89. *See supra* text accompanying note 74.

90. *See supra* text accompanying note 75.

91. Although this problem is recognized with respect to private insurance, is is assumed that government insurance can offer an unconditional guarantee. *See, e.g.*, Diamond & Dybvig, *supra* note 63, at 413 (citing this reason for maintaining government rather than private sector deposit insurance). This presumes that the government will always back up its guarantee by increased taxes, no matter how distortionary. *Id.* at 416. Ideally, once the nature of this unconditional guarantee is understood, it will never have to be called upon. Depositors who know their investments are protected in the event of bank closing have no reason to participate in runs. Thus, an equilibrium can be achieved in which the government's credible promise to pay assures that the promise will never be tested. *Id.* Nevertheless, recent financial crises experienced by government insurance funds suggest that this equilibrium is easily upset.

92. *See supra* text accompanying notes 83–85 (cost test for choosing among alternative dispositions of failed banks).

93. Technically, deposit insurance is intended to be funded through contributions from insured banks. For 55 years (until 1988), the bank insurance fund's annual income, derived from premiums and returns on investment of reserves, did exceed its annual expenses. *See* Rehm, *supra* note 8, at 13, col. 1 (FDIC experienced its first annual loss in 1988).

94. *See supra* note 91.

straints may make these options undesirable or impossible. In requesting additional funds, the deposit insurance fund must compete with other government-funded programs and agencies. In this competition, the insurance fund may not necessarily be perceived as the most deserving recipient.[95] This political reality was demonstrated by the lengthy bargaining process required before a solution was found to the thrift industry crisis. Congress was reluctant to solve the thrift insurance fund's financial problems by measures that would further increase the federal deficit.[96]

The FDIC, which is in charge of administering the deposit insurance fund, is likely to be sensitive to these political constraints. No regulator wants to be remembered as having begged Congress to raise taxes or increase the federal deficit to bail out the insurance fund. Such a request, even if granted, will have a negative effect on the agency's ability to obtain future funding for personnel and internal administrative expenses, as well as on the allocation of power among competing regulators. The FDIC already shares responsibility for federal regulation of the banking industry with two other agencies, the Office of the Comptroller of the Currency and the Federal Reserve Board. The FDIC's chances of gaining additional supervisory power at the expense of its rivals will be injured if the agency's administration of the insurance fund results in its insolvency.[97] Thus, the FDIC has an incentive to minimize the cost of bank failure to the insurance fund.[98]

This goal of minimizing the cost of failure may frustrate attempts to use the bank failure process to achieve other goals, such as punishing investors in bad banks. Assume Bank A has failed, leaving quantities of worthless assets. Bank A purchased these assets with uninsured deposits held by sophisticated investors who deliberately chose to put their funds in a risky bank in order to earn high returns. This bank may seem like a good candidate for a liquidation, as a result of which uninsured depositors will bear losses. Yet the bank may also have so many insured deposits that paying off insured depositors' claims could exhaust the insurance fund. Thus, the FDIC may not have the luxury of using liquidation to impose discipline on uninsured depositors.

In this case, the flexibility of the FDIC to experiment with alternative solutions may enable the FDIC both to save money and to punish uninsured depositors. For example, the FDIC could arrange an insured deposit transfer in which only insured deposits and selected assets are transferred intact to an assuming bank.[99] Nevertheless, even this solution may not be possible for every bank failure. Some purchasers may want to assume uninsured as well as insured deposits. There may be no bidders

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95. Since the direct beneficiaries of the fund are private depository institutions and their investors, there may be reluctance to use public funds to rescue private gamblers.

96. *See* Garsson, *Gramm Fights for Off-Budget S & L Rescue*, Am. Banker, July 31, 1989, at 1, col. 1 (debate over source of funds needed to recapitalize thrift insurance fund delayed adoption of FIRREA).

97. For example, as a result of the problems besetting the thrift insurance fund, Congress abolished the federal agencies responsible for administering thrift insurance, transferring the insurance function to the FDIC. *See* FIRREA, *supra* note 8, § 401 (abolishing FSLIC and FHLBB).

98. This incentive will be strengthened as the FDIC's power grows following the consolidation of the bank and savings association insurance funds under the FDIC's control. *See supra* note 97.

99. *See supra* text accompanying note 35. In this case, uninsured depositors are relegated to the proceeds of liquidation of the bank's remaining assets.

at all for some failing banks, forcing a choice between liquidation and open-bank assistance.

Of course, if the FDIC's failure resolution techniques themselves result in riskier banks, then any short-term cost reduction is counterproductive. The FDIC will be saving money today that will have to be spent tomorrow as even more banks fail. Yet a bank failure policy that reduces outflows from the insurance fund has consequences beyond simply reducing the cost of any single bank failure. If as a result of this policy the insurance fund remains strong, depositors have less reason to join deposit runs.[100] As a result, fewer banks may fail. Moreover, the danger that current bank failure policy is sacrificing the opportunity to impose market discipline on depositors or other bank investors is of concern only if such discipline is likely to produce healthier banks. In fact, encouraging effective market discipline may be an impossible task for bank failure policy.

III. The Problem of Market Discipline

The goals of bank failure policy would be easier to achieve if fewer banks failed. Critics of current bank failure policy often blame that policy itself for removing incentives for healthy banks to avoid failure. In their view, if bank failure policy were altered, bank investors—shareholders, depositors, and other creditors—would have more incentives to monitor bank condition and impose discipline on bank management to limit excessive risk-taking that leads to failure.[101]

Today's bank failure policy cannot afford to be concerned exclusively with creating incentives for market discipline of healthy banks.[102] Yet even if it could be the sole aim of bank failure policy, encouraging market discipline would not necessarily result in fewer bank failures. Shareholders already have reason to discipline their banks, but they have had little effect on currently inflated rates of bank failure. The discipline of uninsured depositors and other creditors is unlikely to be any more effective in limiting risk than the weak discipline imposed by their fellow debtholders on nonbanking companies. Finally, although insured depositors are not expected to exert meaningful discipline, their actions still interfere with the disciplinary efforts of other bank investors.

A. *Shareholder Discipline*

Bank shareholders are no better off as a result of bank failure than shareholders in any failed enterprise. In fact, in most banks, the large volume of creditors' claims, particularly those of depositors, means that shareholders ordinarily can expect to recover less in bank failure than in the failure of many nonbank businesses.[103] Whether the bank's assets are liquidated or transferred to an acquiring bank, very

100. *See* Diamond & Dybvig, *supra* note 63, at 416.
101. *See* Macey & Miller, *supra* note 5, at 1225–26.
102. *See supra* text accompanying notes 92–99.
103. *See supra* text accompanying note 30.

little will be left to satisfy shareholders. Thus, shareholders already have incentives to exert discipline on bank managers to avoid failure.

Yet most observers would agree that shareholder discipline has not sufficiently deterred opportunism, excessive risk-taking, or other managerial conduct that leads to bank failure. This may mean that bank managers can afford to ignore the signals sent by the securities market. Alternatively, bank managers may be reading shareholder signals correctly, but shareholders may not be insisting on more risk-averse management of banks. In this case, shareholder discipline of banks may be working as well as shareholder discipline of any firm, but such discipline will not lead to fewer bank failures.[104]

1. *Can Bank Management Afford to Ignore Market Signals?*

In order to be effective, shareholder discipline must have an impact on bank managers, who set the bank's investment strategy. The case for market discipline assumes that bank managers have adequate incentives to read and respond to market signals. If investors are selling their shares or refusing to buy newly issued stock, bank managers will react by altering their investment strategies to prevent further declines in share value.

Whether bank managers are sensitive to declines in share value is subject to question. Lower share values affect the price at which banks can raise new equity capital. Yet this may have little impact on bank management.[105] Most banks depend for funding primarily on deposits, including insured deposits. So long as these deposits remain available, management can tolerate depressed share prices or even the unwillingness of shareholders to buy newly issued bank stock.[106] Historically, equity levels at many banks have been very low.[107] Bank regulation has had to mandate minimum equity capital to asset ratios of four percent.[108] This suggests that bank managers may be able to ignore the risk preferences of shareholders.[109]

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104. This discussion of shareholder discipline begs the question why managers require discipline in the first place. Put another way, why are managers likely to engage in inefficient investment strategies that fail to maximize firm value? The most common answer is that agency costs involved in monitoring and controlling corporate managers allow those managers to pursue their own goals rather than those of the firm's risk-bearers. *See* Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). Market discipline, if successful, provides a means of more closely aligning managers' and risk-bearers' preferences. But market discipline does not ensure that managers will pursue less risky investment strategies. In fact, at least until the firm is in financial distress, managers are likely to be more risk averse than their shareholders. *See infra* text accompanying note 114.

105. For any firm, lower share prices do not necessarily prevent capital formation. The firm may simply have to issue more shares to raise the necessary amount of capital. *See* Bebchuck, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1845 (1989). Yet issuing more shares at lower prices may increase the administrative costs of the securities offering. The firm may have difficulty placing a large number of shares. It may have to make multiple trips to the equity market, increasing its legal and regulatory costs.

106. If depositors were concerned about equity levels at banks, they might avoid banks that the equity market disfavored. Nevertheless, the protection afforded by deposit insurance allows at least insured depositors to be less concerned about excessive leverage than debtholders in nonbank corporations. Moreover, equity levels have been so low at banks in general compared with nonbank corporations that investors concerned about leverage would have to abandon banks altogether.

107. *See* Walker, *Regulating Capital at the Margin*, 5 ISSUES IN BANK REG. 35, 36 (Autumn 1981).

108. *See* 12 C.F.R. pt. 208; 225 (1989).

109. In addition, managers may have difficulty interpreting market signals. Managers may focus on short-term investor reactions to their conduct and ignore longer-term factors that may affect investor response. Market reactions may

Many proponents of market discipline agree that, for any firm, the stock market alone is an inefficient source of discipline on managerial discretion. More effective discipline is provided by the market for corporate control or the managerial labor market.[110] Shareholder disaffection with a firm, resulting in depressed share prices, will lead to a takeover by more efficient managers who can maximize the firm's value.[111] If managerial compensation is tied to share performance through stock option plans or bonuses, managers' and shareholders' interests can be more closely aligned. In addition, superior stock performance may improve a manager's chance of obtaining a better paying position at another company.[112]

These arguments suggest that, in the long run, management may not be able to ignore market signals.[113] But they do not prove that market discipline will cause bank managers to avoid actions that increase the risk of bank failure. Even without the incentives provided by the market for corporate control and the managerial labor market, managers have good reason to fear bank failure. Bank failure causes managers to lose their jobs, and may affect their ability to find new jobs.[114] In contrast, managers can protect themselves from financial losses following a takeover by negotiating favorable termination arrangements. Moreover, loss of a high paying managerial position as a result of business failure has more serious financial consequences for managers than a decline in the value of their securities holdings.

Thus, even without owning shares or otherwise having an interest in the performance of the company's stock, managers have a significant stake in the continued solvency of their firms. This suggests that managers already have a reason to avoid conduct that increases the risk of failure. Aligning managerial and shareholder interests is not necessary to make bank managers take fewer risks. In fact, as will be shown in the next section, it may make them take more risks.

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be difficult to read, and subject to individual interpretation. A two-point drop in stock price following announcement of loan problems may be viewed as highly negative by one manager, but more positive than expected by another. Thus, even if managers are concerned with market responses, market signals may provide poor guidance to managers in making specific corporate decisions, such as choosing among investments with varying degrees of risk. For a discussion of this problem in the context of market responses to automobile recalls, see Marcus & Bromiley, *The Rationale for Regulation: Shareholder Losses under Various Assumptions about Managerial Cognition*, 4 J. LAW, ECON. & ORG. 357, 361–63 (1988).

110. These two disciplinary mechanisms have been termed "control by displacement" and "control by incentive." *See* Williamson, *Corporate Control and the Theory of the Firm*, in ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES 281, 298-316 (H. Manne ed. 1969).

111. *See* Manne, *supra* note 17, at 112; Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1165–74 (1981).

112. *See* Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 298 (1980).

113. Of course, these disciplinary mechanisms may not work as well for banks as for other firms. For example, critics of bank regulation argue that banks are effectively insulated from the threat of a change in control. Yet the current active bank takeover market refutes this claim. *See infra* text accompanying notes 163–64.

114. Association with a failed bank may damage a manager's reputation for skillful management. Moreover, the job market for senior bank executives may not be active, particularly if the banking industry generally is experiencing financial problems. *See* Coffee, *Shareholders versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 17 (1986) (senior corporate executives cannot assume the existence of an external market rate of return applicable to their labor).

2. *Are Bank Shareholders Risk Averse?*

Bank managers already have significant incentives to avoid bank failure. Long-term employment relationships give managers a large and often undiversifiable stake in their bank.[115] If managerial compensation includes stock options or other performance-related benefits, managers' stake in the continued solvency of their firm is only increased.[116] Moreover, managers are not winners in bank failure. Regardless of regulatory disposition, failure results in lost jobs, causing financial injury as well as damage to the managers' reputations.[117]

If managers are already risk averse, why is market discipline necessary to restrain overly risky managerial behavior? Managers have reason to avoid high risk projects that may lead to failure. They also have reason to monitor their fellow employees to prevent opportunistic behavior that destroys firm value. Nevertheless, banks are still failing.

One explanation may be that, in taking risks, bank managers are responding to the preferences of their shareholders.[118] Shareholders are less risk averse than bank managers or bank regulators might like them to be. Several factors account for shareholders' ability to tolerate bank risk and even bank failure. First, diversification allows shareholders to accept more risk in any individual investment than is acceptable to undiversified investors. Portfolio theory suggests that shareholders can protect themselves from firm-specific risk by investing in different stocks whose returns are negatively correlated.[119] Through this diversification, investors ensure that, at any time, losses from one investment will be offset by gains from other investments. Investors also can reduce overall portfolio risk by buying some low risk assets such as treasury securities. This suggests that diversified shareholders may welcome additional risk-taking by bank management if it offers the prospect of high returns.[120]

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115. *See id.* at 16–24.

116. *See id.* at 18.

117. *See supra* text accompanying notes 113–14.

118. There are several possible explanations for why bank managers might overcome their personal risk aversion. Excessive leverage, although reducing the relative importance of equity as a funding source, may help to align managerial risk preferences more closely with those of shareholders. For example, it has been argued with respect to corporate leverage generally that, through leverage, managers are bonding themselves to accept shareholders' risk preferences, since firms with high debt-to-equity ratios must depend on funding by the equity market for new projects. *See* Coffee, *supra* note 114, at 28 (discussing this pro-leverage argument). Although, unlike other firms, banks can rely on a continuous supply of deposits for funding, recent regulatory requirements that banks maintain minimum ratios of equity to assets may be forcing banks to resort regularly to the equity market. This in turn may be forcing bank managers to become more sensitive to shareholders' risk preferences.

Alternatively, high leverage means that bank managers must invest in increasingly high yielding and high risk projects in order to pay themselves salaries after paying off debt charges. As bank risk increases, so will the risk premiums that must be offered to attract depositors, forcing managers to accept even more risky projects in order to maintain net profits. Thus, it may actually be the pressure of deposit market, rather than the stock market, that is causing bank managers to become less risk averse. *See infra* note 121.

119. *See* R. BREALEY & S. MYERS, PRINCIPLES OF CORPORATE FINANCE 123–26 (2d ed. 1984).

120. Of course, accepting high risk projects is not the only reason that banks fail. Banks also fail because of employee theft or fraud, slack or other inefficient managerial behavior. Since these inefficiencies will not produce high returns, they will not be welcomed by shareholders (or risk averse managers). Yet shareholder discipline has not prevented this type of risk-taking either. Diversification itself may remove incentives for individual shareholders to invest in the costly, firm-specific monitoring that is required to detect internal management problems before they result in failure. Such monitoring is more efficiently performed by potential corporate raiders who intend to improve performance by removing

Second, the high ratios of depositors and other debtholders to equityholders in most banks may contribute to shareholders' preference for more aggressive risk-taking by bank management. As the level of debt, and of debt servicing charges, grows, management must invest in increasingly high yielding projects in order to ensure some return for shareholders after debt charges are paid. Shareholders do not want their banks to invest solely in treasury securities and other "safe" investments that yield only enough to pay off depositors. They prefer that their banks invest in more risky loans with higher yields. The higher the expected return on an investment, the more profits will be available for shareholders. Thus, shareholders' preference for high returns may put pressure on management to choose high risk investments.[121]

Thus, there is no reason to assume that, because banks fail, shareholder discipline is not working. In fact, the current rate of failure may be acceptable to the equity market. Improving the sensitivity of bank managers to the discipline of this market is likely to lessen, not strengthen, these managers' aversion to risk. Perhaps this is why proponents of market discipline ignore the role of bank shareholders in imposing discipline on bank managers. Instead, they appear to agree with the bank regulators that the current rate of failure imposes unacceptable costs on other bank stakeholders, especially the deposit insurance fund.

B. *Depositor Discipline*

Critics of bank failure policy put their faith in depositors and other bank creditors to exert market discipline that will actually prevent bank failure.[122] This reliance on debtholders to discipline management is somewhat curious at a time when the failure of corporate debtholders generally to constrain management risk-taking is becoming evident.[123] Theoretically, debtholders discipline management risk-taking in three ways. First, debtholders can protect themselves from future increases in risk by negotiating restrictive covenants that directly constrain management's discretion to alter the risk posture of the firm. These covenants may prevent management from pledging assets, incurring new debt, or paying excessive dividends.[124]

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incumbent management. Yet, as will be discussed, serious management misconduct that is likely to cause failure may deter these raiders. *See infra* text accompanying notes 177–80.

121. *See* Guttentag & Herring, *Credit Rationing and Financial Disorder*, 39 J. FIN. 1359, 1369 (1984). This pressure increases as the bank begins to experience financial difficulties, at which point management also has an interest in gambling on high risk, high return investments in the hope of preventing salary cuts, *see supra* note 118, and loss of employment if the bank fails. For example, assume a bank has $1000 of debt and only $100 of income. Management has the opportunity to make a loan that has only a 10 % chance of yielding $2000. This investment will be attractive to shareholders, who will receive nothing if the investment is not made, the bank becomes insolvent and the creditors take the $100. It also may be attractive to the bank's managers, who will lose their jobs if the bank becomes insolvent. At best, the risky investment will keep the bank open. At worst, it will at least postpone failure.

122. *See* Macey & Miller, *supra* note 5, at 1199 ("Uninsured depositors are a valuable source of market discipline for banks").

123. *See* Bratton, *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92, 135–59; McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205, 234–45 (1988). These observers have pointed to the failure of bondholders, through restrictive covenants or otherwise, to halt wealth transfers from bondholders to stockholders as a result of corporate restructurings, takeovers, and buyouts. The barriers to effective debtholder discipline are only magnified in the context of bank-depositor relations.

124. For examples of these and other restrictive debt covenants, see McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413, 424–27 (1986).

Second, debtholders can insist that the premium that they receive to lend to the firm reflects the risk that management will accept more risky projects during the term of their loan. Firms that pose a greater than average risk of unforeseeable alterations in risk structure will command higher than average risk premiums from the market.[125] Finally, if the risk associated with an investment is so great that debtholders cannot protect themselves through covenants or risk premiums, debtholders can refuse to renew their loans or to buy new debt. Since this decision deprives the firm of capital, it imposes direct discipline on management's discretion to invest in new risky projects.[126]

Yet none of these devices has had much effect on bank risk. Deposit contracts seldom if ever contain restrictive covenants.[127] Although some banks must offer risk premiums to attract deposits, high premiums have not deterred these banks from making new risky investments with depositors' funds. Moreover, very risky banks continue to be able to attract funds almost until the day they fail. Depositor discipline appears no more effective than shareholder discipline in punishing excessive risk-taking.

1. *Why Depositors Do Not Demand Restrictive Covenants*

For risk-averse debtholders, contractual covenants would seem to offer distinct advantages. Debtholders are concerned about unpredictable changes in risk levels during the term of their investments. Once the premium on its debt has been set, a firm has an incentive to invest in high risk projects that, if successful, will produce returns for shareholders in excess of fixed debt charges.[128] If shareholder discipline is effective, bank management will feel pressure to engage in a high risk investment strategy in order to improve returns.

Restrictive covenants can place direct limits on the ability of firms to take certain kinds of risks, such as incurring substantial quantities of additional debt, pledging assets, or selling subsidiaries. Firms may have an incentive to accept these kinds of restrictions in order to lower their cost of funding. In the absence of direct controls on managerial discretion, debtholders may require large risk premiums to compensate for the possibility of significant future alterations in firm risk. Firms may be able to differentiate themselves from other, more risky borrowers by agreeing to bond themselves to maintain a risk-averse investment strategy. If the cost of such bonding, including forgone investment opportunities, is less than the risk premium that the firm otherwise would have to pay its debtholders, then the firm may choose to accept restrictive covenants.

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125. Risk premiums also compensate debtholders for foreseeable risks associated with the debt instrument at the time of its issuance.

126. *See* Fama & Jensen, *supra* note 72, at 338.

127. This absence of covenants is not unique to deposits. Other short-term debt securities such as commercial paper also are issued with very few if any covenants. *See* McDaniel, *supra* note 124, at 424–26. As in the case of deposits, the short terms of these investments make contractual covenants unnecessary. *See infra* text accompanying notes 137–38.

128. *See supra* text accompanying note 121.

Why then are contractual protections so rare in the deposit market?[129] The regulatory protections enjoyed by depositors provide an incomplete explanation. Deposit insurance protects some small investors, but even uninsured depositors do not contract for additional protection.[130] The absence of negotiated deposit contracts suggests that depositors may not want or need contractual protection. The cost of negotiating contracts may exceed the expected benefits in terms of the effectiveness of restrictive covenants. Moreover, other more efficient techniques of depositor self-protection may exist.

The cost of negotiating contractual covenants is far higher for the depositor than for the average corporate debtholder. Deposits are issued almost continuously with different maturities and rates. A 100,000 dollar certificate of deposit is a very different investment from a checking account.[131] The covenants which each depositor would require are so different that no single agent could bargain effectively on behalf of all depositors. Separate negotiations between each depositor and her bank would be prohibitively expensive, and would result in complex and possibly conflicting contractual requirements for the bank.[132]

Moreover, the effectiveness of contractual covenants in preventing bank risk-taking is subject to question. Restrictive covenants often focus on management's discretion to acquire, substitute, or dispose of assets. Typical covenants restrict the sale of assets, prevent excessive payouts of assets to shareholders in the form of dividends, and impose various other asset maintenance requirements.[133] Covenants restricting the issuance of additional senior or secured debt also seek to preserve debtholders' claims to the firm's assets.[134] These covenants provide a way for debtholders to exert some control over the firm's future investment policy. Ideally, debt contracts would require managers to make only those investments that maximize firm value. But such contracts would be prohibitively expensive for debtholders to monitor and enforce.[135] Instead, standard asset-related covenants set limits on particular investment strategies, such as asset substitution, that can decrease a firm's value.

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129. For the past two decades, even long-term corporate bonds have contained few if any restrictive covenants. *See* McDaniel, *supra* note 124, at 424–26. Apparently, issuers have convinced investors that the cost of contracting exceeds the expected benefits in terms of risk control. Recently, concern over high firm leverage resulting from restructurings has led to the reemergence of some debt restrictions aimed at discouraging highly leveraged transactions. *See* Clemens, *Poison Debt: The New Takeover Defense*, 42 BUS. LAW. 747, 751 (1987) (describing "poison puts" that allow the holder to put the debt back to the issuer at a premium redemption price upon the occurrence of certain restructuring events). Alternatively, bondholders may now be protecting themselves by demanding higher rates and shorter maturities. *See* Bratton, *supra* note 123, at 157 (noting decline in durations of junk bonds). These are the very devices that depositors and other short-term debtholders rely on to protect themselves in lieu of covenanting. *See infra* text accompanying notes 137–38.

130. In some states, depositors are granted a statutory preference over some other general creditors in a liquidation. *See supra* note 27. Yet this may not afford much protection if the failed bank has few valuable assets.

131. *See Banking*, *supra* note 11, at 134–39 (distinguishing "involuntary depositors," such as holders of checking accounts, for whom risk and return are less significant in choosing a bank than factors such as convenience, from sophisticated "investor-depositors").

132. *See Still Banking*, *supra* note 11, at 246.

133. Such covenants may require the maintenance of particular properties, impose minimum working capital requirements, or require the firm to remain in particular businesses. For an analysis of the functions of these and other typical covenants, see Smith & Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 124–46 (1979).

134. *See id.* at 127.

135. *See id.* at 130.

Yet, for most banks, these kinds of covenants are both unduly restrictive and ineffective in controlling risk. Bank assets are constantly being replaced and often have no easily determinable current market value.[136] Thus, asset maintenance requirements are impossible to monitor and enforce. Moreover, these requirements provide very little real protection against a liquidity crisis. Once a deposit run begins, a bank's assets may be depleted so rapidly that remaining depositors have no opportunity to enforce contractual asset maintenance requirements. In any case, liquidity crises are rarely within management's control. Restrictive covenants cannot prevent deposit runs from occurring.

Finally, the liquidity of deposits removes any incentive for depositors to incur the costs of drafting and monitoring compliance with contractual covenants. Most deposits are either withdrawable upon demand or short-term. A short-term depositor has the opportunity at regular intervals to make a new investment decision: she can either recover her principal from the bank or renew her deposit.[137] If bank risk has increased, the depositor can simply withdraw her funds, or insist on a higher risk premium before reinvesting.

If the depositor chooses to withdraw her funds, she has the option of reinvesting in another bank's deposits or in a variety of fungible short-term investments, including treasury securities, commercial paper, and money market mutual funds, all of which offer comparable liquidity and rates.[138] Active trading markets and low investment costs ensure that these alternatives are always readily available. Moreover, these deposit substitutes also are issued without restrictive covenants. An investor can react to increased risk in any one investment by simply shifting her funds to another short-term instrument.

2. *Why Risk Premiums Do Not Constrain Bank Risk-Taking*

Even if depositors do not demand restrictive covenants from their banks, risk premiums also can serve as a check on managerial discretion. Depositors should demand sufficient premiums to compensate them for the possibility of future changes in bank risk.[139] Riskier banks will have to pay higher rates in order to attract funds. Managers seeking to reduce funding costs will find ways to reassure depositors, such as by operating their banks in a risk-averse manner.

So why is the market discipline provided by risk premiums not already effective in reducing bank risk? One problem is that, in the deposit market, partial market

136. Valuing a bank's assets by looking at the dollar amount of outstanding loans does not give a true picture of default risk or of the risk associated with contingent liabilities, such as standby commitments, that do not appear as assets on the bank's balance sheet. These problems in arriving at an accurate measure of true asset value have led the bank regulators to develop complex risk weights for different bank assets as part of their minimum capital-to-asset requirements. *See* 12 C.F.R. pt. 208; 225 (1989). In addition, since no active trading markets exist for many loans, asset value may not represent the actual price at which such loans could be sold to raise cash to pay off depositors.

137. *See supra* text accompanying notes 69–70.

138. *See supra* text accompanying note 71.

139. This discussion relates primarily to uninsured depositors. Insured depositors have less reason to worry about future risk levels at their banks or to demand high risk premiums. But the presence of insured depositors complicates the tactical decisions of uninsured depositors and bank management as to risk-taking. *See infra* text accompanying notes 149–53.

discipline—risk premiums but no covenants—may be worse than no market discipline at all. For example, assume that Bank A's loan losses are so large that it must pay a premium over other bank rates to attract investors for its six-month certificates of deposit. This premium may enable Bank A to find sufficient investors who are willing to tolerate greater than average risk in exchange for high returns. Yet in order to pay these high rates for six months, Bank A will be forced to invest depositors' funds in increasingly high yielding and risky assets. Nothing in the terms of the deposit contract will restrict this or other increases in risk. Thus, rather than constraining bank management, the risk premium demanded by depositors may force even more risk-taking.

Of course, cautious management may prefer to avoid escalating risk and simply withdraw from the deposit market until the bank's financial condition improves. Yet the nature of the banking business may not permit this strategy. The bank may need new deposits to pay off its maturing liabilities, or it will be forced to liquidate assets. Since the bank's assets consist primarily of relatively illiquid loans, forced liquidation of assets may lead to substantial losses on the bank's loan portfolio. Although the bank could ask the bank regulators for financial assistance, the regulators may impose onerous terms on management[140] or, if the liquidity crisis is severe enough, even close the bank. Thus, management will prefer to continue to borrow at high rates rather than to ask the regulators for help.[141]

Moreover, the fact that a bank is willing to pay higher risk premiums on new deposits may itself provide a negative signal to the deposit market. Depositors will view any increase in risk premiums as a sign that management has shifted or is intending to shift into higher risk investments.[142] This signal may affect holders of maturing deposits. These depositors may be averse to any increased risk and may refuse to reinvest their funds. If the bank is unable to find new investors at higher rates to replace these depositors, it may experience a liquidity crisis. The bank may then be forced to offer still higher premiums to compensate new depositors for the increased risk.

3. *Why Risky Banks Still Attract Depositors*

If risk-taking increases too much, eventually most depositors may decide that no premium can adequately compensate them. Once depositors refuse to fund the bank, the bank will fail. The ability of depositors to react to unacceptable risk by removing capital from management's control should be a potent source of discipline.[143] In

140. *See supra* text accompanying note 38 (removal of management as condition to receiving open-bank assistance).

141. This problem has led Congress to try to stop distressed banks from obtaining funds by offering high risk premiums. Recently enacted thrift restructuring legislation prohibits depository institutions that do not meet minimum regulatory capital requirements from soliciting deposits by offering rates of interest "significantly higher than the prevailing rates of interest on deposits" offered by competing institutions. *See* FIRREA, *supra* note 8, § 224. How this prohibition will work in practice is as yet untested. But the prohibition highlights the willingness and ability of troubled banks to fund increasingly risky projects almost indefinitely by promising increasingly high returns to depositors.

142. *See* Guttentag & Herring, *supra* note 121, at 1376 n.20.

143. *See* Fama & Jensen, *supra* note 72, at 338.

effect, depositors' decisions to withdraw funds affect a partial takeover or liquidation of the bank.[144]

Yet once such withdrawals begin, bank management has little opportunity to alter its investment strategy to respond to the market's preferences. The bank already has made the risky investments to which the market is now objecting. Since loans are relatively illiquid and have longer terms than the average deposit, it will take time for management to shift the composition of the bank's loan portfolio. In the meantime, the bank may have difficulty liquidating sufficient loans to pay off departing depositors. The bank will fail before its management can react positively to the market's discipline.[145]

Of course, bank managers can avoid this unpredictable funding risk by operating banks in a more risk averse manner. But managers may have difficulty discerning just how much risk is too much for the deposit market. Since depositors can liquidate their investments at little or no cost, they may hold their deposits until it is clear that the bank is about to be closed. Thus, depositors may continue to fund very risky banks.[146] The signals sent by the market as to how much risk is acceptable may be hard to read.[147]

Moreover, each depositor's assessment of the risk associated with her deposit depends in large part on other depositors' assessments of their own risk. So long as most depositors are not rushing to liquidate their investments, even unprofitable banks may remain solvent. But if large numbers of depositors are withdrawing their funds, then any remaining depositors have reason to join the deposit run to recover their investments before the bank becomes insolvent. At this point, it is too late for depositors to protect themselves by demanding covenants or higher risk premiums from the bank. The actions of their fellow depositors have created an independent and immediate risk to the bank's solvency. Thus, the actions of depositors are often a more significant indicator of bank risk than the actions of management.[148]

Another reason why even risky banks may be able to attract deposits is the presence in most banks of large numbers of fully insured depositors.[149] Deposit insurance removes any reason for insured depositors to invest in ongoing monitoring

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144. *Id.*

145. For firms with illiquid or organization-specific assets, redeemable claims create substantial risks. *See id.* Such firms would incur substantial costs in trying to liquidate sufficient assets to pay off claimants. Although some financial institutions, such as mutual funds, hold marketable securities that can be easily liquidated to satisfy claimants, this is not true of bank loan portfolios. It has been suggested that banks can satisfy their redeemable claims by holding sufficient treasury securities and other marketable bonds. *Id.* at 339. Yet the relatively safe securities that are eligible for bank investment tend to be low yield. As a bank's cost of funds increases, it is likely to shift more of its portfolio into higher risk, higher yielding illiquid loans. Even risk averse banks cannot afford to maintain sufficiently liquid portfolios to guarantee all of their deposits. *See* note 62.

146. There is evidence that otherwise risk-averse depositors leave their funds in financially distressed banks. *See* Dickerson, *FDIC Says Consumers Leave Large Sums, Uninsured, at Weak Banks*, Am. Banker, June 14, 1989, at 7, col. 1.

147. *See supra* note 109 (describing limits on ability of managers to interpret market signals correctly).

148. *See, e.g.*, Chari & Jagannathan, *supra* note 63, at 759 (depositors reasonably infer poor prospects for a bank from the withdrawal decisions of other depositors); Diamond & Dybvig, *supra* note 63, at 410 (anything that causes depositors to anticipate a run will lead to a run).

149. Such depositors may hold accounts of $100,000 or less or may hold insured portions of larger certificates of deposit that have been broken into insured pieces for sale.

of bank risk-taking.[150] Nevertheless, although insured depositors are not likely to check the accuracy of information about their bank, they still may react to this information, whether true or false. This reaction will affect the bank, its management, and its other investors. For example, if a badly managed bank can obtain sufficient insured deposits to meet its funding needs, management may not need to worry about the bank's reputation among uninsured depositors. This bank's access to secure funding sources may sufficiently reassure uninsured depositors that they also may be willing to invest. Yet if negative publicity about this bank suddenly causes insured depositors to panic and withdraw their funds, uninsured depositors now have reason to take note and react accordingly.

Deposit insurance should remove incentives for insured depositors to react to either accurate or inaccurate information about their bank by withdrawing their funds. Thus, the principal hazard created by deposit insurance should be the willingness of insured depositors to continue to fund banks that are excessively risky or mismanaged. If these banks eventually fail, the deposit insurance fund then must bear the cost of reimbursing inattentive insured depositors.

Yet despite the guarantee of deposit insurance, there have been occasions when insured depositors have initiated bank runs, often in response to inaccurate information. For example, when a bank holding company called Beverly Hills Bancorporation missed payments on its commercial paper, depositors confused the holding company with its bank subsidiary, Beverly Hills National Bank, and began withdrawing their funds.[151] In this situation, uninsured depositors cannot afford to sit back and rely on their superior knowledge of the difference between the legal obligations of a bank and its holding company. If the confusion of less informed depositors causes a deposit run, the bank will experience a liquidity crisis and fail.

Thus, in the market for deposits, inaccurate information may crowd out accurate information.[152] Informed depositors must take into account the reactions of less informed depositors, since this reaction itself is significant news. This interferes with the ability of depositors to discipline truly bad banks. This danger that market discipline will be skewed by the inaccurate reactions of uninformed investors is more serious in the deposit market than in other debt markets. Although rumors can affect any capital market, most investors in commercial paper or corporate debt simply do not have the luxury afforded by deposit insurance to remain unsophisticated or

150. Although a distinction is made here between insured and uninsured depositors, some uninsured depositors also are unable or unwilling to engage in the kind of risk analysis of their banks that might be expected of a sophisticated investor. Such depositors may maintain their funds in the bank for reasons having little to do with risk and return, such as the opportunity to obtain other bank services. This author has distinguished "involuntary depositors," including insured depositors and some uninsured depositors such as holders of payroll or escrow accounts that are maintained primarily to obtain other banking services, from "investor-depositors" who view deposits as alternatives to other short-term investments. *See Banking*, *supra* note 11, at 134–39. Only the latter depositors have the expertise and incentive to behave as careful investors in evaluating bank risk.

151. *See* Mayne, *New Directions in Bank Holding Company Supervision*, 95 BANKING L.J. 729, 731 (1978).

152. *See* Chari & Jagannathan, *supra* note 63, at 759 (bank runs can occur even if no one has adverse information about future returns).

uninformed. Thus, the chance of bad information leading to unpredictable runs is more likely in the deposit market than in other markets.[153]

IV. Bank Failure and the Market For Corporate Control

If market discipline by shareholders or depositors is an inadequate substitute for bank failure policy, are there any other mechanisms that may be more effective in controlling bank risk? Critics of bank failure policy occasionally suggest that one factor that has contributed to the high rate of bank failure is the absence of a significant market for corporate control of banks. A healthy takeover market would permit the acquisition of marginal firms that are near failure as well as put pressure on banks to improve their performance in order to avoid becoming targets.[154] Yet bank acquisitions, particularly hostile takeovers, are discouraged by regulation that requires prior regulatory approval of a change in control of a regulated bank.[155] This approval process imposes lengthy delays and additional costs on bidders and provides management with an opportunity to take defensive measures.[156]

Although hostile takeovers have occurred in banking,[157] the approval process for bank acquisitions, as well as many other applicable statutory and regulatory requirements such as federal tender offer regulation[158] and state antitakeover statutes,[159] undoubtedly impose costs on takeovers. Nevertheless, there is no necessary relation between these costs and the frequency of bank failure. The cost of the regulatory approval process has not prevented the development of a healthy takeover market in the banking industry. But in that market, the most attractive candidates for acquisition have not been, nor are likely to be, banks on the road to failure. Thus, encouraging more bank takeovers will not be effective in eliminating weak or failing banks. Finally, to the extent that acquisitions do encourage better management at healthy banks, the regulatory approval process itself may play a significant role in creating

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153. Many observers of bank regulation agree that effective depositor discipline is not possible. *See, e.g.*, Benston, *Financial Disclosure and Bank Failure*, Fed. Reserve Bank of Atlanta Econ. Rev. 5, 9 (Mar. 1984). Some have suggested that other creditors, such as holders of subordinated debt, are more likely to exert discipline. Such debt is not as liquid as deposits and is not protected by deposit insurance. Nevertheless, preliminary studies of the subordinated debt market cast doubt on the effectiveness of even these debtholders' discipline. One such study found risk premiums on subordinated debt to be unrelated to traditional accounting measures of bank performance and only weakly related to private sector bond ratings. *See* Avery, Belton & Goldberg, *Market Discipline in Regulating Bank Risk: New Evidence from the Capital Markets*, 20 J. Money, Credit, and Banking 596, 608 (1988).

154. *See supra* text accompanying note 111; Macey & Miller, *supra* note 5, at 1203–05. Macey and Miller rely on an article by Professor Manne advocating takeovers as a means of facilitating the transfer of assets from inefficient to efficient uses prior to failure. *See* Manne, *supra* note 17, at 112–13.

155. Macey & Miller, *supra* note 5, at 1212–23. This regulation includes the Bank Holding Company Act, which covers bank holding company acquisitions, 12 U.S.C. § 1842 (1982), the Change in Bank Control Act, which covers acquisitions of banks by individuals, 12 U.S.C. § 1817(j), and the Bank Merger Act, which covers mergers of banks, 12 U.S.C. § 1828(c).

156. Macey & Miller, *supra* note 5, at 1222.

157. *See The Bank of New York Company, Inc.*, 74 Fed. Reserve Bull. 257 (1988) (approving hostile bid for Irving Bank Corporation).

158. *See* 15 U.S.C. § 78n(d) (1982).

159. *See, e.g.*, N.Y. Bus. Corp. L. § 912 (McKinney 1986) (forbidding a shareholder that acquires more than 20% of the stock of a New York corporation without the approval of the board of directors from effecting a merger for five years).

these incentives. In fact, the approval process can be a useful tool of bank failure policy.

A. *The Cost of Bank Acquisitions*

Any regulation that requires a bidder to obtain prior regulatory approval of its acquisition of a bank or bank holding company obviously creates certain risks for both bidders and targets. The application process requires the bidder to submit detailed information to the reviewing regulatory agency, involving considerable time and expense.[160] The filing of the application reveals the bidder's intentions to the target's management, which may then take steps to fight the acquisition while the application is pending. The application eventually may be denied, leaving the bidder with considerable expenses and often resulting in bad publicity, particularly if the grounds for denial are the bidder's financial or managerial problems. If the application is approved, so much time may have passed since its filing that the bidder's original offer may have become unrealistic and may have to be revised.

The application process affects targets as well. Target management that wants to resist a bidder may have difficulty finding a white knight. Since rival bidders may themselves have to go through the application process, they will be hesitant to become involved unless the outcome can be assured.[161] The pool of potential white knights is limited by regulation preventing the acquisition of a bank by most nonbanking firms.[162] Even if target management decides to sell to the bidder, it will not welcome delays that may cause the bidder to renegotiate its offer or withdraw it completely.

In view of these constraints on the takeover market, one might expect few mergers or other acquisitions of banks to take place. Yet over the last few years, especially as barriers to interstate banking have been removed, the bank takeover market actually has been very active.[163] Although most acquisitions have been friendly, at least one hostile bank takeover has succeeded with the approval of the bank regulators.[164]

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160. *See, e.g.*, 12 U.S.C. § 1817(j)(6) (1982) (information required to be submitted under Change in Bank Control Act).

161. *See, e.g.*, Matthews & Fraust, *White Knight Drops Its Bid for Irving*, Am. Banker, Aug. 30, 1988, at 1, col. 2 (inability of white knight to meet Bank Holding Company Act's requirements). Even an agreement by a white knight to buy a substantial block of stock to deter an unwelcome raider will require regulatory approval. The Bank Holding Company Act requires prior regulatory approval of the acquisition of control of a bank, which may exist when a purchaser buys as little as five percent of the bank's voting stock. *See* 12 U.S.C. § 1842(a) (1982). The Change in Bank Control Act may require prior notice of acquisitions of ten percent of the bank's voting stock. *See* 12 C.F.R. § 225.41(b)(2) (1989).

162. *See* Bank Holding Company Act § 4(c)(8), 12 U.S.C. § 1843(c)(8) (Supp. V 1987), *amended by* FIRREA, *supra* note 8, § 601 (permitting holding company acquisitions of thrifts).

163. The average annual number of bank mergers in the 1980s was triple that of the 1960s and double that of the 1970s. *See* Hunter & Wall, *Bank Merger Motivations: A Review of the Evidence and an Examination of Key Target Bank Characteristics*, FED. RESERVE BANK OF ATLANTA ECON. REV. 2 (Sept./Oct. 1989). Under the Bank Holding Company Act, states have the authority to permit or forbid acquisitions of banks operating within the state by out-of-state bank holding companies. 12 U.S.C. § 1843(d) (1982). Over the past five years, many states have permitted limited or full entry by out-of-state bank holding companies. *See* Savage, *Interstate Banking Developments*, 73 Fed. Reserve Bull. 79 (1987). Changes in state law generally have been followed by frenzied takeover activity.

164. *See supra* note 157 (Bank of New York/Irving). Although a subsequent highly publicized hostile bid by NCNB for Citizens & Southern failed, this defeat was hardly evidence that hostile takeovers are impossible in banking. Rather, the legal and tactical manoeuvering by both bidder and target suggested that the bank takeover game is becoming just like

This suggests that the cost of the application process, although not insignificant, may have less of a deterrent effect on bank acquisitions than has been assumed. Certainly, the acquisition process is not much more costly than other avenues of bank expansion. A bank looking to expand its banking operations into a new market has two options: it can acquire an existing bank or it can enter the market de novo by forming a new bank or branch. Yet opening a new bank or branch also requires the bank to obtain prior regulatory approval.[165] There is no evidence that the cost of the acquisition process has caused banks to prefer expansion by chartering new banks or to avoid expansion altogether.

Moreover, the cost of the approval process often is matched, if not exceeded, by other legal barriers to takeovers. For example, The Bank of New York's hostile bid for Irving Bank Corporation was approved by the Federal Reserve Board,[166] but was delayed by a state antitakeover law that prevented completion of a hostile takeover for five years.[167] In addition, Bank of New York had to commence lengthy judicial proceedings to challenge Irving's poison pill.[168] Nevertheless, almost eight months after regulatory approval was granted, Bank of New York won its battle to acquire Irving.[169] Although the additional costs imposed on the bidder by both the banking and corporate laws may be substantial, they have not prevented the development of a market for corporate control in banking.[170]

It is generally assumed that prior regulatory approval requirements especially deter hostile takeovers of banks by forcing bidders to reveal their intentions and giving targets time to take defensive measures.[171] Yet most defensive measures, such as poison pills and other charter changes, can easily be adopted well in advance of an actual takeover threat.[172] The ability of target management to take some defensive measures, such as selling the bank to a white knight, is limited by the same regulatory approval requirements that delay hostile bids.[173]

Moreover, the regulatory approval process does not necessarily favor negotiated mergers over hostile bids. In approving Bank of New York's application to acquire Irving, the Federal Reserve Board explicitly refused to distinguish between friendly

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other corporate takeover battles. For a discussion of these tactics, see Murphy, *A Path Twice Taken: NCNB's Unsuccessful Pursuit of C & S*, 8 BANK EXPANSION RPTR. 1 (June 19, 1989).

165. *See, e.g.*, 12 U.S.C. § 36(c) (1982) (national bank may establish new branch with approval of the Comptroller of the Currency).

166. *See* 74 Fed. Reserve Bull. 257.

167. N.Y. BUS. CORP. L. § 912 (McKinney 1986).

168. Irving had adopted a Shareholders' Purchase Rights Plan that would have permitted Irving shareholders to buy $400 of an acquiring company's stock for $200. This provision was declared invalid by a New York court. *See* Matthews, *Irving Loses Appeal On Poison Pill Plan*, Am. Banker, Oct. 5, 1988, at 1, col. 4.

169. *See* Fraust, *Irving's Rice Gives In to Hostile Bid*, Am. Banker, Oct. 6, 1988, at 1, col. 2. Irving surrended only after its poison pill was invalidated. *See supra* note 168.

170. It is noteworthy that bank equity investors believe that an active market exists for corporate control of banks. During the first half of 1989, the best performers among bank stocks were those that were viewed as likely targets for acquisition. *See* Matthews, *Bank Stocks Outperform the Market; Takeover Candidates Are Big Gainers*, Am. Banker, July 12, 1989, at 2, col. 2.

171. *See* Macey & Miller, *supra* note 5, at 1217–18.

172. For example, C & S had put into place antitakeover devices such as a staggered board long in advance of NCNB's hostile bid. *See* Murphy, *supra* note 164, at 15.

173. *See supra* text accompanying notes 161–62.

and hostile acquisitions, rejecting Irving's argument that hostile takeovers are harmful to the banking industry.[174] The Board's principal concern was that defensive measures and legal battles unrelated to the regulatory approval process would delay consummation of the acquisition.[175] This suggests that the bank regulators are not permitting targets to use the regulatory approval process as a defense to hostile takeovers.

Finally, the steps leading to a hostile bid are not so different from those leading to a friendly merger. The bidder first will approach target management (and the appropriate bank regulator) with its offer. If the price is attractive, target management may decide to sell even if the bank was not previously in the market for a buyer. The bid will become hostile only if management rejects the offer. Even if the regulatory approval process deters some bidders from going forward with hostile offers, hostile acquisitions are not necessarily more efficient than friendly acquisitions. Inefficient managers of unprofitable banks may be attracted by an opportunity to sell out at a premium, particularly if they are also shareholders. Efficient managers may have good reasons to resist an inadequate offer. Thus, there is no reason to assume that hostile takeovers of banks result in better allocations of resources than friendly takeovers.

B. *Acquisitions and Target Banks*

Even if the cost of the regulatory approval process does in fact deter some takeovers, dismantling this regulation and facilitating bank acquisitions is unlikely to reduce bank failure rates. Many bank failures are caused at least in part by insider abuse, fraud, or serious mismanagement.[176] Although not all such bad banks fail and there are other causes of bank failure, badly managed banks pose a sufficient risk to the regulatory system that their elimination through acquisition would be desirable.

Yet this sort of bank is hardly likely to be an attractive candidate for acquisition, particularly by a hostile takeover. Fraud in a bank has proven very difficult for outsiders to detect until its effect on the bank has become serious. Even the bank regulators have been frustrated in attempts to identify and correct insider abuse before it leads to failure.[177] A rival bank looking for an acquisition target will be unlikely to discover fraud. In a hostile takeover, the bidder will not be given an opportunity to conduct any due diligence investigation of its target. Even in a friendly acquisition, the target has a reason to hide serious management problems that could cause the bidder to lower its offering price.

Moreover, if a bank's management problems are serious enough to become apparent to the regulators or the market, then many potential bidders will be deterred. Few bidders want to take the risk that the bank's former management has incurred huge contingent liabilities that are discovered only after the acquisition is completed. This problem already faces the FDIC in attempting to arrange mergers of banks that have failed because of serious insider abuse. Even if the FDIC finds a willing buyer,

174. *See* 74 Fed. Reserve Bull. 257, 259.

175. The Board denied Irving's request for a formal hearing on the application and was reluctant to extend the 90-day period for consummation of the acquisition following regulatory approval. *Id.* at 271–72.

176. *See supra* note 59.

177. *See supra* note 66.

that buyer may require such a large indemnity against future liabilities that the cost of arranging the merger exceeds that of liquidation.[178] Bidders for failed banks at least have the opportunity to do a preliminary evaluation of the bank's condition.[179] In a hostile takeover, the bidder has no opportunity to evaluate how deeply the effects of mismanagement have been felt by the bank.

Thus, bad banks do not make good targets for acquisition.[180] Bidders are likely to be more attracted to banks that possess a valuable asset that the acquiring bank needs. For example, a bidder which itself is heavily dependent on purchased funds may be attracted by a target bank's stable base of core deposits, which provide a reliable source of inexpensive funds. An established branch network may be a value to a bidder seeking to expand into new retail banking markets.[181] The target bank's unique market position, which may result from expertise in particular operations such as trust or securities services or simply lack of competition, may attract a bidder with complementary strengths.[182]

These banks will be takeover candidates only if they are reasonably priced. A bidder will not buy a bank to get its branch network unless the cost of acquisition is less than the cost of building a branch network in some other way. Thus, banks will be attractive targets if their assets are undervalued by the market. But banks with depressed share prices are not necessarily problem banks on the road to failure. A bank's share price may be low because its management is overly cautious and has not exploited its assets to the fullest extent.[183] The bank may be underleveraged,[184] or may invest in safe but low yielding assets.[185]

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178. *See* J. SINKEY, PROBLEM AND FAILED INSTITUTIONS IN THE COMMERCIAL BANKING INDUSTRY 37–38 (1979).

179. In addition to providing information, the FDIC occasionally has allowed bidders access to the failed bank to permit a review of its condition. *See* Bovenzi & Murton, *supra* note 2, at 12.

180. *Cf.* Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1203–04 (1984) (noting that the level of risk associated with nearly insolvent firms makes them unlikely candidates for acquisition). Studies of past bank mergers have failed to find empirical support for the proposition that bank acquisitions are undertaken to improve the efficiency of mismanaged institutions. *See* Hunter & Wall, supra note 163, at 11. Instead, most mergers appeared to be motivated by opportunities for improving economies of scale or increasing market concentration. *See id.* at 5–10 (summarizing prior empirical research on bank acquisitions).

181. When state restrictions on interstate banking limited opportunities to acquire healthy out-of-state banks, many banks were willing to pay premiums to buy failed out-of-state banks or thrifts in order to build an interstate network. *See Citicorp, New York, NY*, 68 Fed. Reserve Bull. 656 (1982) (acquisition of failed out-of-state thrift). Now that interstate banking barriers are disappearing, the attractiveness of failed institutions as targets also has diminished. *See supra* note 163 (changes in state laws prohibiting interstate banking); FIRREA, *supra* note 8, § 601 (amending 12 U.S.C. § 1843(c)(8) to permit bank holding companies to acquire healthy thrifts).

182. For example, Irving's leadership in computerization and data processing was one of its major attractions to Bank of New York. Moreover, since Irving's capital investment in computer equipment had depressed its earnings and stock price, this expertise could be acquired relatively cheaply. *See* Neustadt, *Rice's Expertise in Technology May Have Led Irving into Trouble*, Am. Banker, Oct. 6, 1988, at 15, col. 1.

183. *See supra* text accompanying notes 114–17 (tendency of management to be risk averse).

184. Although banks in general are highly leveraged, some banks actually have higher equity to asset ratios than are required by banking law or preferred by shareholders.

185. That there may be a difference between a "bad" bank—a problem bank on the road to failure—and an undervalued bank can be illustrated by a simple example. Bank A invests in low risk loans and liquid treasury securities. These investments are adequate to cover Bank A's debt charges and produce a small return for shareholders. Bank B invests in high risk loans, a quantity of which are nonperforming. Although its interest income from its risky portfolio remains high, it must pay substantial risk premiums to attract deposits, reducing its net profits. As potential equity investments, both banks under current management present a risk of low earnings, and share prices will be depressed accordingly. But as potential takeover targets, Bank A presents less risk than Bank B. An acquiring firm can pay a low

Threat of a hostile takeover may cause this management to become more aggressive in order to improve the bank's performance and increase its share price. If management thereby operates the bank more efficiently, then the pressure exerted by the threat of a takeover is beneficial. Yet there is also a danger that, in order to keep share prices high, management will engage in increasingly risky behavior to improve performance. This pressure will be especially strong when the banking industry in general is suffering an economic downturn.[186] If loan spreads are low, management may make increasingly risky loans in order to prevent a decline in earnings. These actions may satisfy bank shareholders. Yet management also may be increasing the risk of bank failure.

Alternatively, bank managers who fear takeovers may react like managers of nonbank corporations and put into place shark repellents and other antitakeover devices. These actions may have unintended consequences for bank failure policy. Some of the measures that bank managers may adopt to discourage takeovers may simply be bad banking policy. For example, a bank holding company may commence an acquisition program with the intention of becoming too large for most raiders to swallow.[187] Yet these acquisitions may prove difficult to integrate with existing operations or to manage effectively, ultimately weakening the banking organization. And if the bank fails, it now may be too large to permit an easy regulatory disposition.[188]

C. *Takeovers and Regulatory Discipline*

Encouraging a more active bank takeover market is unlikely to have much of an effect on bank failure. Nevertheless, the regulatory approval process itself may play a role in encouraging better management of banks before they fail. As part of the regulatory approval process, the bank regulators evaluate the financial and managerial resources and future prospects of the bank holding companies and banks involved in an acquisition.[189] The regulators can use this authority to condition their approval

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price for Bank A, sell its securities portfolio and reinvest the funds in higher yielding loans, thereby improving earnings. Improving Bank B's earnings will require new managers to work through Bank B's loan problems and gradually shift the composition of Bank B's loan portfolio into less risky assets in order to persuade depositors to accept lower risk premiums. Before this can be accomplished, Bank B may fail as a result of deteriorating assets, inability to attract sufficient funding, or both.

186. The tendency of the takeover market to concentrate on particular depressed industries has been noted. *See* Coffee, *supra* note 180, at 1210–11. In recent years, the stock market has tended to penalize entire classes of banks, such as money center or regional banks, making them inexpensive targets for other banks.

187. If such acquisitions require prior regulatory approval, the approval process may prevent this defensive tactic. *See supra* text accompanying note 173.

188. *See supra* text accompanying notes 99–100 (describing constraints on regulators' choice of disposition of failed banks). Ironically, a possible motivation for some bank acquisitions is the desire to become "too big to fail"—to hold so many insured deposits that in the event of financial distress the regulators will be forced to arrange a merger or provide open-bank assistance. If uninsured depositors view large banks as liquidation-proof, banks have an incentive to grow in order to attract these depositors. An unregulated bank takeover market that facilitates growth-motivated mergers would only increase the regulators' existing problems in disposing of failed banks.

189. *See* 12 U.S.C. § 1842(c) (1982) (Bank Holding Company Act); 12 U.S.C. § 1817(j)(7)(C) & (D) (Change in Bank Control Act); 12 U.S.C. § 1828(c)(5) (Bank Merger Act).

of an acquisition on the acquiring bank's taking certain steps, such as improving its capital or its target's capital, that will strengthen the combined enterprise.[190] The regulators can deny an application if they determine that the acquisition is likely to weaken the acquiring bank.[191]

Thus, the approval process is one of the few remaining sources of regulatory pressure on bank management to reduce its risk-taking prior to actual failure. Once a bank has failed, it is too late for the FDIC to bring regulatory pressure to bear. The agency's main concern is to arrange the rapid disposition of the failed bank's business at the lowest possible cost.[192]

In contrast, in a healthy bank acquisition, the regulators can look closely at the condition and prospects of both the bidder and the target. Although this regulatory discipline primarily affects the bidder, the outcome of the regulatory approval process affects targets as well. Although the regulators cannot ensure that all bad banks become targets, they are likely to approve a change in control of a weak bank. Moreover, they can insist that the bidder takes steps to strengthen the target, including redeploying assets and increasing capital. Finally, they can prevent weak banks from trying to solve their problems by acquiring still weaker banks.[193]

Of course, the regulators' exercise of this discretionary conditioning power may increase uncertainty as to the outcome of a bid, discouraging some takeovers. Yet fear of negative publicity following an actual denial of an application[194] causes most bidders to approach the regulators privately before formally filing an application. The regulators provide some indication of what, if any, conditions they may impose on the applicant, enabling the bidder to assess the cost of the acquisition. As these conditions generally involve raising new capital, the bidder must take into account the equity market's probable reaction to its acquisition.[195]

Critics of regulation are uneasy about entrusting bank regulators with this discretion over the takeover market. Regulators may be biased for or against acquisitions or may make the wrong judgment in individual cases. Some potentially efficient mergers may never take place. Many candidates for bank failure will never go through the application process and will avoid this discipline.

In part, these objections raise the question of why the regulators are any better

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190. *See The Bank of New York Company, Inc.*, 74 Fed. Reserve Bull. at 264–65 (requiring Bank of New York to raise additional equity capital to support cash portion of its offer for Irving). In some cases, the regulators require the applicant to raise capital above the minimum regulatory capital requirements in order to offset any unanticipated losses resulting from the acquisition, such as difficulties in integrating operations. *See id.* at 265.

191. For example, the Federal Reserve Board denied an application by Franklin National Corporation, parent company of the troubled Franklin National Bank, to acquire a nonbank financial company on the ground that the acquisition would interfere with the holding company's efforts to strengthen the bank. Several months later, the bank failed. *See* J. SINKEY, *supra* note 178, at 148.

192. *See supra* text accompanying notes 92–100.

193. For example, the Federal Reserve Board's insistence that the pro forma capitalization of the resulting company following acquisition at least equal the target's capitalization prior to acquisition discourages acquisition of strongly capitalized banks by weaker bidders. *See* Murphy, *supra* note 164, at 15.

194. For example, the denial on financial grounds of Franklin National's application to acquire a nonbank subsidiary raised doubts about the solvency of Franklin's subsidiary bank, leading to deposit runs. *See* J. SINKEY, *supra* note 178, at 148.

195. *See* Murphy, *supra* note 164, at 15.

than shareholders, depositors, or bidders at identifying and disciplining problem banks. The relative superiority of the unregulated market or of the government in achieving this or any other policy goal is likely to be subject to ongoing debate among banking law scholars and economists generally.[196] There is a tendency to cite problems with one approach as a complete justification of the other approach. For example, the high incidence of bank failure prior to the development of modern banking regulation is support for continuing regulatory intervention. Conversely, regulatory errors in handling individual bank failures are treated as sufficient reason for deregulation and reliance on market forces. In fact, either argument proves only that neither market nor regulatory solutions to the bank failure problem are likely to be perfect.

A better approach may be to compare, to the extent possible, the efficacy of market and regulatory forces in achieving desired outcomes. Bank failure is sufficiently costly that reducing the incidence of failure is desirable.[197] Experience has shown that regulation cannot prevent bank failure, but, as this Article has suggested, there are also serious impediments to effective discipline by other bank stakeholders.[198] Because of the deposit insurance system, however, the regulators have a more direct stake in preventing bank failure than shareholders, depositors, or bidders.[199] Moreover, although imperfect, the regulatory discipline exercised through the application process is likely to have a more direct impact on bank management than other disciplinary efforts.[200]

V. The Future of Bank Failure Policy

Ultimately, the principal objection to current bank failure policy is that it does not prevent bank failure. Yet, as this Article has pointed out, this goal may be unrealistic. So long as bank failure policy must take into account the cost of failure

196. *See, e.g.*, Wolf, *A Theory of Nonmarket Failure: Framework For Implementation and Analysis*, 22 J.L. & Econ. 107 (1979).

197. *See supra* text accompanying notes 78–79 (costs of bank failure).

198. *See supra* text accompanying notes 103–53.

199. *See supra* text accompanying notes 92-100.

200. Proponents of a more active takeover market may argue that regulatory review of acquisitions is unnecessary, since the equity market will discourage inefficient takeovers by penalizing the acquiring firm. As previously argued, however, shareholders may have difficulty making their discipline felt through market signals. *See supra* text accompanying notes 105–09. Moreover, this faith in the securities markets to prevent inefficient takeovers is somewhat puzzling. If bank shareholders are capable of identifying and penalizing poor management decisions, then reliance on acquiring firms to remove bad management is unnecessary. Target company shareholders should replace inefficient managers themselves, removing the need for a takeover. If individual shareholders are too dispersed and powerless to discipline management through ordinary market mechanisms, then the only way to discipline inefficient takeovers is for another raider to take over and bust up a firm that has made a bad acquisition. Maybe this does occur. *See* Coffee, *supra* note 114, at 2–3 (describing "bust-up" takeovers). But it is doubtful that this really is a more efficient way to police inefficient bank takeovers than the regulatory approval process.

Regulatory conditioning power may also be criticized when the agency uses its power to impose new, controversial policy without the opportunity for public comment or judicial review. *See* Aman, *Bargaining For Justice: An Examination of the Use and Limits of Conditions by the Federal Reserve Board*, 74 Iowa L. Rev. 837, 886–98 (1989). In reviewing the financial condition and management of merging banks, however, the regulators' use of conditioning power is fully consistent with the individual scrutiny contemplated by the bank acquisition statutes. *See id.* at 888.

to the deposit insurance fund, it cannot be concerned solely with creating incentives for better management of healthy banks. Moreover, the ability of any bank failure policy to create these incentives seems doubtful.

Thus, critics of bank failure policy should be looking at how successful that policy has been in achieving realistic goals. If the cost of failure resolution must be the primary consideration, does current bank failure policy in fact result in the least costly solution? Failure costs might be reduced further if problem banks were closed more promptly.[201] New, potentially less costly methods of handling failed banks might be tried.[202]

More generally, evaluation of bank failure policy requires some rethinking of the goals of bank regulation. Critics who fault bank failure policy for the current rate of bank failure may be misassigning the blame. Problems with bank failure policy reflect the failings of the deposit insurance system and of regulation of healthy banks. Reforming bank failure policy first requires some action to relieve pressure on the deposit insurance system, either by curtailing insurance protection[203] or by ensuring the system's adequacy to deal with more frequent and costly bank failure. Despite the recent recapitalization,[204] the insurance fund still may not be adequate to handle future bank failures if they continue at present rates. The regulators still must be primarily concerned with minimizing the cost of failure to the insurance fund, despite the consequences of that policy for bank investors, managers, and the banking system. Any change in this bank failure policy will require the commitment of substantial additional resources to the insurance system.

More fundamentally, a decision must be made about the level of government regulation of healthy banks that is desirable to achieve an appropriate rate of bank failure that can be handled by the insurance system. The crisis recently experienced by the thrift insurance fund, and related concern over the bank insurance fund, have temporarily halted debate over deregulation or reregulation of healthy banks. Yet the question of healthy bank regulation affects bank failure policy. Regulatory resources can be devoted either to finding ways to control bank risk prior to failure or to dealing with the consequences of more bank failure.

These issues are not likely to be resolved rapidly. In the meantime, banks are failing and the bank regulators are left to manage the consequences. Operating under these conditions of uncertainty, current bank failure policy has proved remarkably successful.

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201. For example, appointment of a receiver for a bank as soon as losses have exhausted its equity capital may limit opportunities for the bank's shareholders and managers to continue to gamble with depositors' funds, increasing the ultimate cost of a regulatory disposition. *See supra* note 121 (describing shareholders' and managers' incentives to gamble as bank condition deteriorates); *see also* Office of the Comptroller of the Currency, Rules, Policies and Procedures for Corporate Activities; Receivership and Conservatorship, 54 Fed. Reg. 28,072 (July 5, 1989) (proposal to declare national banks insolvent when losses eliminate equity capital).

202. Since the cost of failure resolution is of direct concern to the FDIC, the agency itself continuously experiments with new approaches. For example, recently the agency has been developing procedures that would allow more bidders to compete for failed banks. *See* Bovenzi & Murton, *supra* note 2, at 13.

203. *See supra* note 13 (describing proposals to limit insurance coverage).

204. *See supra* note 8.

VI. Conclusion

Bank failure policy is not designed to produce more perfect banks or to assign responsibility for bank failure to shareholders or depositors. It is designed to facilitate the rapid reallocation of banking resources following bank failure. In achieving this goal, current bank failure policy is more efficient, and far less disruptive, than alternative bankruptcy or reorganization procedures.